PRIVATIZATION: AN ANSWER TO THE SANDINISTAS

by Stuart M. Butler

Privatization, in the sense of the transfer of a government activity in whole or in part to the private sector, has attracted worldwide interest in recent years. In the developed world, Britain has taken the lead with sales of government assets totaling more than $20 billion during the 1980s. Britain has privatized many key companies, including its telephone system and most recently its national airline, British Airways. In addition, more than one million public housing units have been sold to their tenants, and over 600,000 government employees have been transferred to the private sector.

Yet privatization is by no means confined to the developed world. It is a growing phenomenon in the less developed countries (LDCs). The Asian countries have been in the forefront of this privatization, but increasingly the countries of Africa and Latin America are turning to the concept. Why is this happening? The principal reason is that the previous strategy of trying to encourage economic growth through central planning and public ownership has not worked. In addition, there has been a revolution in the thinking regarding development economics. The orthodoxy of central planning that emanated in large part from British universities has been overtaken by economic doctrine based on the idea that free and open markets, reduced regulation, and a stimulus to small entrepreneurship are the best vehicles for economic development. In addition, there is now a growing appreciation that many basic services, such as communications and municipal services, which previously had been assumed to be uniquely government functions, can in fact be provided far more efficiently by private sector operators.

In Central America, privatization also offers an opportunity to build support for capitalism among ordinary people. By linking the concept with the idea of widespread ownership, particularly among employees and small investors, privatization transforms public ownership into ownership by the people. By offering a strategy for economic democracy, it may enable those who believe in economic and political liberty in Central America to avoid the common and unpleasant dilemma of choosing between a Somoza or the Sandinistas--corrupt, inefficient, centralized capitalism or corrupt, inefficient, centralized socialism. By combining a reduction in the size of the government sector with decentralization and wider ownership, privatization may thus be the vehicle to build a "third way" in Central America, based on free enterprise and mass private ownership.

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Privatization can take many forms. The most common and widely practiced, in both the developed world and the LDCs, is the sale of government assets. This is the usual approach for inherently commercial activities, but it also can be applied to noncommercial activities, such as public housing. A second form of privatization is known as "contracting out." In this case government continues to finance the activity, but it does not perform it directly. Instead it invites private firms to compete in the marketplace for a contract to provide a service. A third form of privatization involves the use of vouchers, which are certificates of a given value that can be used by beneficiaries to purchase goods or services in the private market. Vouchers can be used to enable low-income people to obtain services where there is already a thriving market but the prevailing price is out of their reach. The technique is used in the United States, for example, to enable low-income people to purchase food with "food stamps" or to obtain adequate rental housing with housing vouchers. A fourth form of privatization involves simple deregulation, whereby markets that have been monopolized by government are opened to private competition. In many cities of the world, such as Manila and Calcutta, mass transportation is provided by private bus systems, instead of the regulated monopolies common in Europe and North America. But in many cases, regulations are simply ignored, leading to "creeping privatization." In Lima, Peru, for instance, a vast underground economy provides mass transit, road construction, garbage removal, and many other services through the illegal underground economy.

In each of these forms of privatization, there tend to be four distinct benefits. First, the introduction of private ownership and competition leads to improved efficiency and to a stimulus for economic expansion in an otherwise moribund economy. Not only do management and worker incentives improve, but privatization also allows private capital to flow into commercial activities that had been starved of capital under the public sector. Second, the revenue obtained from the sale of assets or the reduced cost of contracting out and vouchers enables governments to channel resources into basic infrastructure and other public activities, rather than into loss-making firms and services. Third, the savings obtained from privatization can also be used by government to create a climate more conducive to general risk-taking and enterprise in the economy through such actions as tax reduction. But fourth, and perhaps most important in the context of Central America, various techniques of privatization allow governments to generate new capital in the economy by spreading ownership widely. Changing the ownership of firms, housing, or other assets can change people's attitude toward investing in such firms either in cash or "sweat equity." That is, they have the incentive to use their own hard work to create or improve an asset, rather than borrowing to finance it. This can be critical in addressing what is often--quite wrongly--perceived to be a capital shortage in the LDCs. Deregulation and other privatization approaches thus can unlock dormant sources of capital by igniting the underground economy, causing it to expand and to become the driving force of the whole economy.

Experience shows, of course, that it is insufficient merely to point out the economic benefits of privatization in order to see it put into practice. As with any fundamental change of policy, privatization provokes the opposition of many groups who feel threatened by it. Transferring assets and services from the public sector to the private sector is a distinct threat to three groups especially--the government bureaucrats who oversee the departments responsible for these activities, the managers of the industries involved, and the workers in those industries. Each fears for his job and his power. But fortunately, the experience of privatization around the world indicates that it is possible to design strategies that are highly effective in overcoming these obstacles. In particular, it turns out that the economic improvements that come from privatization, in the form of increased efficiency and of the value of an asset, can be used in part to buy out interest groups that otherwise would thwart the process. Thus part of the economic gain of privatization may be used as an "investment" to win support for the action that will produce the gain. With this in mind, leaders in Central America should perhaps consider a number of approaches that have proved to be effective, and might be particularly appropriate in advancing privatization in Central America and reaping the political and economic harvest that accompanies the strategy.

First, if privatization is to be successful, it appears necessary to appoint a high-ranking government minister as the official responsible for the program. It is a simple fact of life that emperors do not readily abandon their empires, nor bureaucrats their bureaucracies. So it is perhaps no surprise that, if a department of government is asked to abandon some of its functions to the private sector, it can come up with all manner of reasons for delaying or preventing the change. Those countries that have moved forward rapidly with privatization invariably have appointed as the minister in charge a very senior official, not just one in charge of a department providing services or operating assets. In this way, the policy is pursued by an official who does not have a direct vested interest in retaining his own and other functions in government hands.

Second, governments would be wise to look at deregulation and contracting out as a means of stimulating small enterprise and the underground economy. Studies of job creation and economic growth around the world show very clearly that the spur to economic and employment expansion comes from new, small enterprises rather than large firms. Thus using privatization techniques to stimulate these small entrepreneurs, which are the dominant form of enterprise in the underground economy, would be very effective in generating rapid economic growth. As Hernando de Soto, of Lima's Institute for Liberty and Democracy, demonstrates in his brilliant book, El Otro Sendero (The Other Path), the underground economy is vitally important in Latin America. In Peru, de Soto estimates that 40 percent of gross national product comes from underground economic activity. Yet in most countries, the underground economy is considered a problem, not a solution, and government goes out of its way to try to regulate it and tax it out of existence. De Soto argues, rightly, that the policy of government should be to unleash the underground economy through deregulation and consider it as the vital base of the entire economy. Privatization thus should seek to open opportunities for this critical part of the economy. If governments were to do this in Central and South America, the effect on economic growth could be dramatic.

Third, LDC governments contemplating privatization should study the remarkable successes of local ownership models. This strategy can have remarkable results, and it would deal in part with the issues of supposed capital shortages as well as the problem of privatizing loss-making concerns. There is already some appreciation in Latin America of the importance of worker-ownership as a means of changing incentives and building support for capitalism among the workforce. The most important example of this, as a product of Latin America, is the Solidarista (Solidarity) labor movement. In a typical Solidarista association, the employee contributes 3 to 5 percent of his pay to a fund, matched by the company, which is then invested or used to create wholly employee-owned firms. The Central American Solidarista movement now involves over 1,600 firms and 170,000 workers in Costa Rica and many other companies and their employees in other countries. These associations have been very successful in generating new enterprises and strengthening the commitment of workers to a successful firm.

Other types of worker-ownership have been similarly successful. In September 1986, for example, the owners of the La Perla coffee plantation in northern Guatemala transferred 40 percent of the ownership of the plantation to the workers, financed by a self-held mortgage repayable over ten years. This ownership stake not only encouraged the workers literally to fight for their plantation against insurgents, but it has also encouraged them to think differently about the improvement of the plantation. Having been unsuccessful in obtaining international bank funds for a 40-mile road to link the plantation with its primary distribution center, the workers are about to start constructing the road themselves. Not only is this an indication of the attitude of the workers when they own part of a firm directly, but it also says something about the nature of capital. There is a tendency in Central America to believe that capital improvements can only take place if a bank--and preferably a foreign bank--provides the cash. Yet capital is no more than saved earnings. So if work is put into creating capital assets rather than into earning money for consumption, it is no different than investments in the form of borrowed cash--except that no repayments are necessary. Thus the plantation workers were using their sweat and time in place of outside finance. Encouraging savings and such sweat equity is a vital antidote to the drug of foreign debt.

If Central American countries were to combine privatization with employee ownership of the privatized companies, they would thus address several concerns. Such employee buyouts or transfers would give the employees a direct benefit and incentive to support privatization, just as they clamor for worker-ownership in private companies. The strategy would also allow Central American governments to link privatization with the popular Solidarista movement. Incentives for workers to build up companies they partially own would help deal with the alleged problem of capital shortages. And the new incentives would improve the efficiency of the privatized firms.

The experience of worker buyouts of government-owned companies in Britain shows that the effect on the efficiency of the firm can be staggering. The National Freight Corporation was once a heavily loss-making nationalized trucking company. In 1982, the government intended to close down large segments of the company and sell what was left to private trucking firms. The employees and management countered with a proposal to buy the company. This was agreed to by the government in 1982, and the entire company was privatized, with the workforce owning 85 percent of the stock. Immediately the worker-owners began to tackle the featherbedding and workrules that had created endemic inefficiency in the company. Soon the company began to turn around, and now it makes a substantial profit. Indeed, a unit of stock that was worth $1 when the company was privatized is now worth more than $40.

A fourth aspect of privatization to consider is that it can be used to strengthen formal capital markets and capital formation further by encouraging small investors. In Britain, the sales of nationalized companies have been combined with campaigns to encourage small investors, including employees and consumers of company products, to purchase shares. This has been important in many ways. In particular, it has attracted new sources of capital by encouraging households who previously had never invested in private companies to come forward. The result in Britain has been that the number of households owning stocks of any kind has grown 400 percent since 1979. In privatization sales, the British government now routinely gives preference to small investors in the distribution of stock and provides discounts on the price of the stock to employees and customers. In addition, the British government generally prices stock offerings slightly below market in order to ensure investors of a healthy premium, thus generating enthusiasm for future offerings.

It is not only in Britain that this strategy has proven very successful. Recently the Jamaican government sold its National Commercial Bank in a similar fashion by giving preference to small investors. The campaign to sell the stock was so successful that the issue was 100 percent oversubscribed, and created 40,000 new stockholders. That privatization alone caused stock turnover in the Jamaican stock exchange to double last year.

Fifth, LDC governments should take steps to use potential privatization gains to buy out key constituencies who might oppose transfers to the private sector. The improved efficiency possible with privatization means that the interests of key constituencies, such as bureaucrats, managers, and employees, can be secured, and at the same time, net benefits can accrue to the economy as a whole. In Britain, for example, the privatization of large companies usually involves the provision of discounted stock and stock options to employees and senior managers. In this way, groups who otherwise might oppose privatization are provided with a vested interest in being sure the strategy takes place. Moreover, earmarking part of the gain from privatization for these constituencies invariably turns them into strong advocates of privatization, thereby also giving them an incentive to increase the efficiency of the privatized firm. This, in turn, boosts the value of the company and hence the proceeds of the sale. Thus it is often possible for the government actually to increase its total revenue from a sale by making such an investment in constituency "buy outs." Similarly, it is usually better to provide stock benefits or positions within the firm to the government administrators associated with the companies than to try to push them aside.

In conclusion, then, privatization is a technique that can produce economic growth through improved efficiency and new capital formation. But more than that, it is a process that creates genuine ownership of the means of production by the people. Unlike the socialist dogma of public ownership (which in reality means ownership by nobody other than government officials), privatization promotes the idea of citizen capitalism. In Central and South America, it could be the vehicle for a quiet revolution which will further the move toward strong democracies in the region. And by promising economic improvement and political freedom, this revolution is far more exciting for the people of Central America than anything Commandante Ortega can promise.

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