

Privatization—A Device for Reforming Public Enterprise Sector in Pakistan

ISTAQBAL MEHDI

Privatization as an instrument for development is finding significant currency in industrial and developing countries throughout the world. Typically, its need arises from the concerns over efficiency with which the state can manage public enterprises (PEs) or large and growing claims of these enterprises on national budgets. In Pakistan its need emanates from both. Barring a few years in the early 1970s, the policy of development through private enterprise remained the mainstay of the Government of Pakistan (GOP) economic policy throughout the four decades of the country's life. In fact, a policy of privatization i.e., transferring public assets to the private sector control remained an enunciated policy in the 1950s and the 1960s, which was again adopted in the late 1970s. However it was not until late the 1980s that concerted efforts were mounted to breath life into the moribund programme of privatization. In developing a programme for privatization the question faced by us concern the size of the existing PE sector, its performance, constraints in and prerequisite for privatization. The most important question is can we privatize all PEs, if not, then what productivity enhancing measures can we take for enterprises which cannot be privatized in the immediate future.

SIZE AND PERFORMANCE OF PEs SECTOR

In the past 40 years PEs have emerged in the entire gamut of economic activity of Pakistan and their number has increased from 12 at the time of independence to more than 200.¹ According to a report by the Auditor General (AG) office the number of these enterprises extend to 257 with the assets of about 276.7 billion (i.e. US \$ 11.5 billion).² The annual report on the "Government Sponsored Corporations" (GSC) shows that in 1988-89, 154 PEs contributed 6.7

Istaqbal Mehdi is with Experts Advisory Cell, Ministry of Production, Islamabad.

¹Istaqbal Mehdi (1987) *The Role of the Public Sector in Developing Countries: Pakistan*. Ljubljana (Yugoslavia). (ICPE Country Studies Series No. 4.) pp. 46-47.

²"Investments and Loans of the Federal Government in Public Enterprises". Lahore: Office of the Auditor General of Pakistan. June, 1989.

percent of the total GDP, but if the contribution of PEs in Water, Railways, Civil Aviation and Telecommunication etc. is taken into account then this share works out to around 13 percent.³ PEs share in the developing countries range between 7 to 13 percent it varies from 2 to 3 percent in Philippine and Nepal to as high as 38 percent in Ghana and Zambia.⁴ The size of PEs in Pakistan thus does not appear to be excessive by international standards.

Owing to multiple objectives i.e., commercial and non-commercial, assessment of asset utilization in PEs is a complex task. The most important element which influences the PEs performance is government control on prices of their inputs and outputs. Barring a few manufacturing enterprises prices of almost all PEs are directly or indirectly controlled by the government which in turn influence their sales as well as profits. Despite, this the AG Report shows that in 1987-88 the return on government investment works out to 8 percent.⁵ The GSC report demonstrates that in 1988-89, 154 PEs return on net shareholder equity works out to 10.4 percent. In addition, enterprises paid total taxes of Rs 25.8 billion which is 26.7 percent of total consolidated tax received by the Government. during the same year these enterprises have generated a saving of Rs 24.8 billion against an investment of Rs 26.8 billion leaving a gap of only Rs 2 billion i.e. 7.7 percent.⁶

The analyses of the financial performance also show significant number of negative trends. They are:

- (a) Since inflation in Pakistan is approximately 9 percent and the interest rate around 15 percent enterprises generating less than this return on assets can be considered giving negative return on assets employed. There are only six enterprises which in 1988-89 gave a return above 15 percent and ten enterprises which gave returns above 10 percent;⁷
- (b) Out of 154 GSC enterprises at least 51 units with about 12 percent assets are incurring losses. In the manufacturing sector alone 5 units with about Rs 2 billion assets are closed down; and
- (c) In 1988-89 out of 356 companies listed at the Karachi Stock Exchange (KSE) 44 belong to the public sector. These companies with 56 percent

³Government of Pakistan, Ministry of Finance (Economic Adviser's Wing). "Government Sponsored Corporations, 1988-89". pp. 18-19.

⁴Leroy P. Jones (1980) Efficiency of Public Manufacturing Enterprises in Pakistan. Islamabad: Ministry of Production.

⁵Auditor General's Report. *Op. cit.*

⁶Based on Government Sponsored Corporations. 1988-89.

⁷Constance R. Church (1990) State Owned Enterprises: Do The Ends Justify the Means. Report prepared for USAID. Nov. 15 p. 10.

share in assets contributed 45 percent of the sales and generated only 38 percent net profit. Similarly their share in corporate tax was 37 percent and dividend at 35 percent.⁸

Indeed the above discussion demonstrates the effects of the negative element of public ownership rather than inefficiency of management. This, however, is consistent with the notion that generally public-sector firms have higher cost structures. A primary conclusion of a survey of PEs all over the world is that they have not performed upto the expectations to their creators and funders.⁹ In Pakistan also such conclusions have, strengthened the case for economic reforms in which privatization plays a major role.

CONSTRAINTS IN PAKISTAN'S PRIVATIZATION PROGRAMME

A number of constraints influence the speed and process of the privatization effort. There are:

1. The supply of capital is the major constraint in the implementation of the privatization programme. At present, the government seeks potential investors to pick up controlling shares and guarantee the repayment of all the loans etc. Even if we go by the book value of the GSC enterprises then we are faced with the demand of capital to guarantee Rs 747 billion and equity worth around Rs 125 billion.¹⁰ This is an excessive demand on the available capital market. According to one study the market capitalization of the shares of KSE is around Rs 50 billion which offers investment of Rs 1 billion. The study recommends that the government should offer shares worth Rs 1 billion of profitable enterprises to the public for the next three years;¹¹
2. There is resistance from various economic groups who will directly be affected by the privatization programme;
3. There can be considerable delays arising from legal problems in the implementation of the privatization programme. The legal constraints range from ownership of specific nationalized assets (e.g. land title of

⁸State Bank of Pakistan (Statistics Department). Balance Sheet Analysis of Joint Stock Companies Listed on the Karachi Stock Exchange 1983-89.

⁹John Nellis (1990) Privatization in Reforming Socialist Economies. Paper submitted in Conference on Privatization in East Europe. Ljubljana, Yugoslavia, Nov.

¹⁰Government Sponsored Corporation, 1988-89 *Op. cit.*

¹¹M. Tech (1990) "Privatization in Pakistan". Islamabad. August. p. 19.

institutions for (i) the effective implementation of privatization policy; and for (ii) improving performance of PEs which shall not be privatized in the near future.

I. Requirements For Privatization Programme

The efficient implementation of the privatization programme has two basic requirements:

- (a) A legal framework; and
- (b) An effective organization to carry out the task.

(a) Legal Framework

The establishment of a comprehensive legal framework is a critical requirement to facilitate the implementation of the privatization programme. Presently privatization is carried out under the existing laws. For instance, privatization of manufacturing enterprises is taking place by making various amendments in the economic reform order 1972. A comprehensive enabling act, designed specifically to facilitate a comprehensive privatization plan offers the following advantages: (a) the law making process can build a political constituency for privatization and a greater public understanding of its objectives, thus reducing political opposition during the implementation phase; (b) an enabling law cannot only serve as a legal authority for the sale of public property but also provide a check-list of required steps to ensure fairness. Indeed, the legislation can establish or mandate the establishment of standards to govern the divestiture process; and (c) finally, the enabling act can provide appropriate legal authority for the administrative agencies which oversee privatization.¹²

(b) Organizational Requirements for Privatization

At present privatization task is entrusted to the privatization commission a semi-independent body which has a wide-ranging scope as reflected in its terms of reference. Although, it is managed by experienced persons but the operational effectiveness of the commission is restricted by the limited professional and support staff available to it. It needs to be supported by an institutional arrangement whereby good technical advice from the consultants, investment banks and law

¹²Michael L. Hager (1988) A Legal Framework for Privatization. Paper presented at Round Table Meeting in Ankara (Turkey). pp. 2-3.

firms in designing a strategy towards the programme of valuing firms and negotiating with buyers etc. is available to it. The immediate task before the commission is to address issues which will need to be dealt by high level of professional support. Some of these are as follows:

- (a) In dealing with the wide range of PEs involved in a variety of activities and financial situations the privatization process shall need to use a range of techniques of privatization. These techniques include straight disinvestment to giving out PEs on contract or leasing, etc.¹³ A programme of privatization classifying PEs according to the appropriate technique of privatization shall need to be developed;
- (b) In the past decade or so in the manufacturing sector GOP policy has been to encourage the private sector and the public sector was expected to focus on consolidating its operations. Consequently, there has been very little investment in public sector enterprises for modernization and replacement purposes. Therefore, barring a few new units most of the manufacturing enterprises are capital starved and shall require a significant amount of investment immediately after privatization;
- (c) Similarly, the past reorganization in the public manufacturing sector was carried out in 1978-79. Since then a number of enterprises have become economically unviable. For example, by international standards some of the cement units are too small for operation and there is a case for mergers to make them economically viable. This exercise can be carried out either before privatization or if sold to a single buyer immediately after privatization;
- (d) A need for re-structuring mergers, etc. is also needed because of the of forward and backward linkages of various enterprises; and
- (f) The most complex task in the privatization process is to provide realistic pricing services for financial assets of varying qualities. Without this there can be little direct or indirect intermediation between investors and savers, whether it is for a new share offering or for the direct sale of an enterprise.

ORGANIZATION FOR PRIVATIZATION

In order to address the issues mentioned above there is clearly a need of

¹³Charles Vuilsteke (1988) *Techniques of Privatization of State Owned Enterprises Vol I, Methods and Implementation.* (World Bank Technical Paper.) Washington, D. C. The World Bank.

a highly professional institutional organized on the pattern of a merchant bank. This organization whether in the public or in the private sector will conduct the following tasks:

- (a) Develop a criteria for selecting and prioritizing units for privatization;
- (b) Develop a criteria for working out the price of an enterprise;
- (c) Work out the pricing of shares to be offered and provide underwriting services involved;
- (d) The financial and other information to be offered in the prospectus or other documents;
- (e) Evaluate an enterprises on the basis of earning capacity for going concern and market value of assets for offers;
- (f) Evaluate enterprises value on the basis of earning capacity and market value of assets for offers;
- (g) Examine proposals for purchase received from general public;
- (h) Assist the buyer of a unit in assessing the needs of rehabilitation work, financial restructuring, etc. Arrangement of additional investment through arranging loans or equity directly or through other institutions or the market;
- (i) Select techniques of privatization according to the specific position of an enterprise. For instance, (a) straight disinvestment to the highest bidder for some units, (b) for certain profit making units the instrument of 'Mutual Funds' or Modarba could be used for their broad based ownership, and (c) for certain loss-incurring units the instrument of management contract or leasing could be arranged. Developing appropriate contracts and effective monitoring of the implementation of the contract etc. could also be carried out by this institution; and
- (g) Develop and implement a programme of managing the pool from the sale proceeds for workers welfare. The task will involve retraining of the retrenched workers and providing loans for their self-employment.

II. Institution For Managing and Controlling Performance of Public Enterprises

Both domestic and international experience demonstrate that privatization is a long, drawn process. While certain enterprises are transferred relatively easily others will take a longer time. In view of the inter-dependence of the privatized and non-privatized enterprises it is imperative that the performance

of the latter is kept at a high level otherwise the inefficiencies of the PEs will be transferred to privatized enterprises which may adversely effect the process of privatization.

Improving the performance of the public sector enterprises is a complex task. The most critical element determining the performance is quality of government control on PEs. Keeping a delicate balance between effective accountability and autonomy is critical for attaining this objective. This in turn requires an efficient monitoring and evaluating system to assist the controllers in attaining the objectives of productivity improvement. In a discussion on productivity improvement in PEs through efficient control systems the mention of experience of the Experts Advisory Cell (EAC) and the signalling system is inevitable. The EAC experience of establishing and operating the signalling system which comprises an incentive-linked-performance evaluation system has been a subject of debate within and more so outside the country. The system which was pioneered in Pakistan and subsequently followed by South Korea, India, Mexico, etc. has been the subject of emulation and debate.

While there has been an acknowledgement on the impact of the system, there are certain issues as well as criticism raised regarding operations of the system:

- (i) The first criticism is that in operating the system private instead of originally envisaged public profitability is used as the primary criteria of evaluation. It is maintained by some authors that only the application of public profitability at constant prices could help in improving productivity.¹⁴ The EAC's view is that while public profitability is certainly a superior indicator but in view of administrative difficulties one can start with the modified private profitability and move gradually towards the use of public profitability. Modified private profitability as used by the EAC takes into consideration the public profitability elements;
- (ii) Another question raised is regarding the impact of the system on performance. It is argued by the EAC that since the inception of this system in 1984 the pattern of profitability of the units governed by this system has changed i.e. from a fluctuating trend to a consistently rising one. Secondly, a survey of 50 enterprises performance in terms of total factor

¹⁴Mary Shirley (1987) *Assessment of the Industrial Public Enterprise Performance Evaluation System*. (Draft) p. 53.

productivity reveals that they have experienced an improvement of 5 percent during the period 1984 to 1989;¹⁵ and

- (iii) Another comment on the operation of the system is that it is managed by a public sector agency. Even if it has made positive impact in the past what guarantee do we have regarding its continuity? This argument addresses a major issue regarding public ownership. The answer to this is to privatize the operations of the control systems. A highly professional consulting body or the bank proposed for assisting the privatization process can take up the task of monitoring and evaluation for all the major PEs which will take sometime to undergo privatization process. The task entrusted to the private body shall be a completely new experience. Therefore, an elaborate arrangement has to be made for this. It will comprise the following elements:

- (a) The target setting and monitoring of the performance of PEs shall require legislative cover (as is experienced in South Korea);¹⁶
- (b) The performance targets and the evaluation itself shall be carried out by the Private Institution in consultation with an agreed Council of Advisers which will comprise experts from Professional Institutions such as Institute of Chartered Accountants etc. (Again on the pattern of the South Korean experience);¹⁷
- (c) Information shall be provided by the private institution to the decision-makers in the respective ministry etc. on laid down formats and according to an agreed schedule; and
- (d) The private institution shall charge a fee for the task of monitoring and evaluation.

¹⁵For a discussion on signalling system experience see; (i) Javed Masood. "Privatization and Deregulation in Pakistan; Policy Framework and Strategy. July, 1991 (Draft) pp. 17-21. (ii) Mary Shirley. Assessment of Industrial Public Enterprises *op. cit.* (iii) and by the same author "The Reform of State-owned Enterprises: Lessons from World Bank Lending" *The World Bank* 1989. pp 31-32. (iv) I. Medhi. "Performance Evaluation of Public Enterprises in Pakistan: An Experiment in Social Accounting System". *The Pakistan Development Review*. Vol. XXIII: Summer-Autumn 1984. Papers and Proceedings of the First Annual General Meeting of the Pakistan Society of Development Economists. (March 17-20, 1984). Pakistan Institute of Development Economics, Islamabad.

¹⁶In-house Study of Experts Advisory Cell (EAC).

¹⁷Young C. Park (1986) A System for Evaluating the Performance of Government Invested Enterprises in the Republic of Korea. (World Bank Discussion Paper No. 3.)

Comments On
“Privatization—A Device for Reforming Public
Enterprise Sector in Pakistan”

The privatization debate in Pakistan has to be seen in the context of the low levels of efficiency in the public enterprises, the financial resources of the government and inadequate competitive elements. The paper throws some light on this issue. The main objective of the paper is not why to highlight the significance of the public enterprises (PEs) in various sectors of the economy and but also to prepare an agenda for improving their performance. The paper concludes that through appropriate restructuring and privatization, the performance of these PEs can be improved.

The paper, while assessing the performance of the PEs, very rightly, draws attention to the conflict arising between their social and economic goals. The multiplicity of objectives in the PEs, no doubt, creates a vagueness in the minds of the management at the time when the performance of these enterprises is evaluated which eventually affects their overall efficiency adversely. The paper describes the situation as it is and suggests no remedies in the agenda to tackle this problem. One way to handle such a situation would have been to make sure that the same criterion is used at the evaluation stage on the basis of which the project was approved.

The basic weakness in the paper is the neutrality of the author who does not take any position either in favour or against the public sector enterprises. For example, on page 41 while discussing privatization as a concept to improve the efficiency of PEs, the paper argues in favour of the two empirically verifiable propositions, i.e., the improvement of productive efficiency at the level of the firm, and the reduction of the budgetary burden for the public enterprises. But on page 44, Jones (1985) is quoted to have rejected the aforementioned propositions. Again, the paper cites two studies on the divestiture of the British and European telecom firms, regarding the positive impact of the divestment (page 44). But then on page 45 it points out that the studies due to methodological problems could not assess the impact of change in ownership on the performance of the enterprises. What exactly does the author want to convey here is not known to the reader. If the objective here is to review the literature on the subject then he has left out two recent studies one by Khan and Reinhart (1990) and the second by Sarmad (1991) (published in the current volume). The former

provides empirical evidence for 24 developing countries in favour of the superiority of the private sector. The latter, using the same methodology with Eighties data and choosing 26 developing countries including Pakistan, has proved that the public sector is more productive than the private sector.

The paper favours phased privatization and denationalization. So far so good. There is no doubt that if successfully managed a privatized economy is far more efficient and less wasteful. However, the paper ignores one crucial fact and that is that the Pakistani private sector is totally family-oriented and always plays a no-risk game. It makes profits even before it invests any money and it takes risk only if the money is borrowed from the banks.

Denationalization which is a zero-sum game and which only transfers ownership is also not a solution to the current problems of the PEs. It can be done later. What is required right now is to go for new industrialization.

In Pakistan there appears to be a general consensus that the motive underlying the rejuvenated faith in the private sector is the Government's need to supplement resources at its command. But the experience in developed countries shows that even where there is a sophisticated finance infrastructure, it is difficult to establish the appropriate market value for the assets of the enterprises. The problem of valuation and public sale are compounded in developing countries where the capital market is insufficiently well-developed to handle large equity sales.

In the present political and economic scenario, privatization should not be given top priority. I am making this suggestion in view of the adverse repercussions of privatization on the employment situation. There is already acute unemployment in dynamic as well as the static sense. Privatization will further aggravate the situation. We should make the PEs more efficient through a comprehensive programme and the elimination of the various tiers of control that impede the smooth and efficient functioning of the PEs through unnecessary and undesirable interruptions and delaying procedures.

Finally, the paper gives a detailed account of issues regarding the public sector and privatization but there are no conclusions. No clear message comes out to guide the policy-makers. It would have helped the policy-maker a great deal if the message was given succinctly and clearly.

Shamim A. Sahibzada

Pakistan Institute of
Development Economics,
Islamabad.