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Privatization, the change in ownership of an enterprise from the public to the private sector, has been a centerpiece of the market-oriented development strategies employed in developing countries over the past two decades. Most economists have evaluated privatization schemes on efficiency grounds alone, leaving distributional concerns to the political process. This paper argues that the distributional impact of policy changes are of major concern to economists, and develops a political economy approach to examine the distributional impact of privatization in developing countries.

A Political Economy Approach

How does privatization affect economic welfare? Who gains and who loses from this policy change? Such questions present a paradox to conventional thinking about the political decisions of state actors.

The changes in welfare associated with privatization can be simplified by considering the following equation:

$$\Delta W = \Delta S + \Delta I + \Delta P$$

Here, welfare changes (W) are separated into a change in consumer surplus (S), a change in rents (I)received by the providers of inputs (i.e. labor), and a change in firm profits (P). If greater efficiency reduces profits then consumer surplus will be positive. The change in factor rents would probably be negative (publicly owned enterprises often have above market wages), and if the privatized firm's financial performance improves, then the change in profits will also be positive. This paper focuses on the latter variable. The distribution of the change in profits between the seller (the state) and the buyer (a private firm) is determined by the negotiated price at which the enterprise is sold.

The act of privatization poses a dilemma for conventional economic theories about state actors. This literature sees the policy maker as a rational self interested actor dependent on social and state forces which seek to advance their own interests by influencing the policy process. In such a framework, the state is an agent of various interest groups that negotiates the transfer of income and wealth among different factions.

In this light, the economic crises of the developing countries are seen as a result of self interested state actors' over-subsidization of those who influenced economic policy. A shift to privatization by these actors would thus seem irrational. Why would it be in the state's interest to sell off the friends that it bought off?

This paradox can be partly resolved in three ways. First, it is perfectly consistent with the new political economy literature that state policy makers will represent private sector interests. Privatization would then represent a change in the means of distribution rather than the ends. Second, state actors can be seen as 'enlightened' technocrats who gamble the state's interests but receive ex-post validation for their good economic policy. Some point to the success of the East Asian economies as an example. Bureaucrats in these countries are said to have acted independently of interest group pressure to pursue economically efficient policies. The rapid growth associated with these efforts let to great gains for many of the key interest groups associated with the state.

Third, and perhaps most important in the context of developing countries, is the influence of other economic factors on the privatization process. The fact that so many developing countries were facing balance of payments shortfalls and other macro-disequilibria forced many of them to change their ways. By opening the sale of private enterprises to multiple bidders, governments were able to increase potential revenue yields -revenues that they needed very quickly.

The form of privatization affects the state's ability to control its distributional impact. In general, the more transparent and 'open' is the privatization process, the less control the state will have over distribution, leaving it less able to serve its constituents' interests. For example, stock market flotation may give a state a lot of revenue, but allows almost no state control over who purchases the sales. On the other hand, closed sales allow governments to influence who will benefit from privatization. The next two sections outline how these choices have come into being on the international stage.

The International Dimension

From 1988 - 1992 privatization efforts surged in the developing countries. During this period, revenues increased from $2.6 billion in 1988 to $23.1 billion in 1992. The biggest recipients of this activity were nations in Latin America and the Caribbean -accounting for 70 percent of all of the privatization in the developing world. The leading sector for privatization was in infrastructure, and the second most important was industrial production.

Who have been the purchasers of privatized enterprises? Foreign investment is increasingly the source of funds for privatization. In 1988, foreign investors had participated in only seven developing country privatization sales, but in 1992 they participated in 191, for a total of 375 over the entire period, 1988-1992. From 1988-1992, privatizations accounted for close to 10 percent of all foreign direct investment flows to the developing world.

Privatization presents developing country governments with a distributional dilemma. The developing countries desperately need funds from their privatization schemes, but they also want some deal of control over who receives the benefits. However, the exertion of control over the process may scare away foreign investors.

Again, the pressure of balance of payments shortages and other macroeconomic disequilibria force nations to come up with quick funds. If the FDI is there it is hard to turn away. Secondly, the international financial institutions such as The World Bank and related institutions have actively encouraged privatization in developing countries. Close to 70 percent of all structural adjustment loans and 40 percent of sectoral adjustment loans during the 1980s had a privatization component.

The Domestic Dimension

A brief examination of the Malaysian privatization experience can illustrate the political economy approach to privatization policy. (See the sources cited in the original article for greater detail and documentation)

Malaysia was one of the earliest countries in the developing world to start a privatization program, committing to privatization in 1983. The goals of the program were to reduce the financial and administrative burden on government, to promote efficiency and competition, and to stimulate private investment. Foreign investment however, was to be limited to 30 percent of that private investment.

The record in Malaysia suggests that privatization was often used to enhance the wealth of certain groups closely aligned with the government. In important cases there was not an open sales process. The ruling party at the time had control over a good deal of the corporate sector, and the privatization process strengthened the party’s corporate interests and the party's rule in the country. The literature shows that by and large, the Malaysian government used privatization as an instrument for the distribution of privatized assets and associated rents to favored groups close to the government party. Setting aside a percentage of privatized assets for indigenous people, a much-discussed government initiative, may have been more successful in creating inequality within the indigenous population than in raising the fortunes of that group as a whole.

Summary and Conclusions

A political economy examination of privatization schemes in developing countries reveals that privatization occurs to promote specific interest groups' economic interests, rather than the advancement of communal welfare. Privatization has usually benefited the same interests and groups that were favored before such schemes were employed. The more transparent and open the privatization process, the less the state can control the distribution of the benefits. Economists’ analyses of privatization have been skewed by an over emphasis on efficiency concerns, and have overlooked the crucial dimension of distribution.