Privatization of Government Enterprise: The Challenge to Management

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The decade of the eighties will be recorded as the period when governments throughout the world embarked on an ambitious program to transfer ownership of governments enterprise to the private sector. The magnitude of this change in ownership structure is enormous: the World Bank reports over 80 nations have programs underway involving the transfer of ownership of thousands of government owned enterprise. This process, called privatization, will have significant impact on how these enterprises are managed, the goals and objectives they pursue, and the task environment of managerial decisions. It is an emerging public policy that will affect the managerial decision process in these and related enterprises for the foreseeable future. Management scholars will be unable to ignore the effects of privatization in the study of competitive strategy, social issues, and employee relations.

How Firms Became Government Owned

An understanding of how firms came to be a state-owned enterprise is useful as a backdrop to understanding privatization. Many theories state ownership of enterprise in market economies have been offered.

First is promoting economic development. This includes promoting development in depressed areas, or nations seeking to develop their economy. State-owned enterprise is also useful when economies of scale favor development of large integrated projects rather than smaller dispersed projects. In many less developed countries state ownership is the only practical way to capitalize large enterprise. This due to capital flight out of the country, a lack of indigenous capital, or a lack of confidence in the future economic climate of the nation. Another economic justification for state-owned enterprise is when high risk discourages private investment (Prichard, 1983; Austin et.al: 51-60).

Second is to simply capture revenue, and earn positive returns for the general treasury, particularly when the enterprise is dealing with a national resource. Venezuela nationalized its petroleum industry for this reason in 1975. (Austin et.al.: 51-60).

Third is to rescue failing enterprise. The American government's acquisition of Conrail was largely in response to a failing rail freight system in the United States (Austin et.al.: 51-60).

Fourth is to specifically accomplish social goals, which include using state enterprise is to enhance programs in the national interest. This includes programs such as state-owned and operated health care systems, improving urban/regional balance, maintaining and improving employment opportunities, ownership of military supply enterprises, or maintaining a technological competency within a nation (Austin et.al.: 51-60; Prichard; 1983).

Fifth is to enhance political or economic control. This includes moderating the impact of economic-based economic decision, controlling externalities, or enhancing national security.

Sixth is a philosophical reason, based on Rawls' (Rawls, 1971) argument that all groups in society should benefit from economic growth, and that the least advantaged group should benefit at least as much as the most advantaged group. The objective of state-owned enterprise would be to improve social equity in terms of pricing of goods and income distribution, as well as promotion of social equality within the workplace.

Managers or privately-owned firms have a reverse set of obligation: achieve a certain level of profits using whatever legal means are available, and if those profits are achieved, the pursuit of secondary public or social goals is acceptable. Managers of state-owned enterprises are often obligated to make decisions that are economically suboptimal to achieve the primary public policy and social objectives, which are many and often conflicting.

Seventh is a subtle for the occurrence of state-owned enterprise: the shaping of the political culture. Certain political pressure groups will lobby for state ownership of enterprise, perhaps to secure job retention, promotion of a new technology, or to control resources. The result of this shaping of the political culture has been to create an electorate favoring more liberal or left leaning governments. When the electorate is living in government owned housing, earning their wage from a government provided sources, they are likely to support more liberal governments (Curry: 18-19; Kay & Brittan: 18-38).

All of the reasons for public ownership are inherently based on this fundamental principle: state-owned enterprise is obligated to fulfill multiple public purpose objectives, some of which are explicitly social. The transition to private ownership changes this; the fundamental objective becomes one of earning a certain satisfactory level of profits. (Cohen, 1963). The situation changes for managers also. Managers of state-owned enterprise are charged with achieving these multiple public policy goals, and to be responsive to multiple constituencies. These may include providing an environment favorable to economic development, providing basic social services, or to nourish a technology base important for the economic figure of the nation. In addition to these justified public policy objectives, special interest groups may pressure managers through influential political actors to sustain artificially high levels of employment or wages, continue offering products or services at prices below their economic value, continue the use of inefficient technology to protect powerful suppliers, or to offer high-paying jobs to well connected political allies.

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Rationales for Privatization

Privatization can occur in three primary ways, including two variations of privatization that are usually included in the concept that are not associated with an actual transfer of ownership (Konrad: 81-91). Divestiture is the most complete form of privatization, where the ownership, control, and operating authority of the organization are legally transferred to a private entity. Divestiture may take place in several forms. The enterprise may be sold as a going business, either through a stock sale to a dispersed ownership, or as a sale to one acquiring firm. Alternatively, the divestiture may take the form of asset sales, where he business as an operating unit is broken down into various assets, which are sold off separately. Divestiture may be of the entire enterprise or of only a part.

Contract management is the transfer of operating responsibility of a government operation , without transferring the legal title and ownership. These arrangement are usually for a fixed period of time. Typically a firm with technical expertise will enter into a contract to provide management services, while using the existing facilities, capital assets, and personnel of the enterprise.

Contracting out is the purchase of services that had previously been performed by the government itself. In this case a firm enters into a contract to provide management services, facilities, capital assets, and personnel. The firm winning the contract may or may not integrate the existing facilities, capital assets, or personnel into the new operation.

Divestiture is the most important form of privatization for management researchers. Government divestiture of an enterprise is fundamentally different from a private firm divesting itself of an operational unit. Any enterprise that is operated under some level of government is justified by serving a public function. It may be in terms of economic development, human service, or that which is inherently a public activity, such as military force. Public policy justification of state ownership is characterized by multiple objective, and satisfies multiple constituencies. Profit generation may be a desirable secondary benefit of state owned enterprises, but it is generally not the primary justification. The existence of public objectives and social goals, often conflicting, are the necessary and sufficient reason for state-owned enterprises. This is not for a private enterprise, where any legal activity that can be carried out profitability is justified. Government-owned enterprise has a fundamentally different objective: to serve the public, either directly or indirectly; profit generation is not a sufficient or necessary objective. When a government enterprise is divested to the private sector, it is transferring ownership of an enterprise that had been justified in terms of public service. When a private firm divests itself of an operating unit, the fundamental objective of that unit, earning a certain level of profits, does not change.

The reasons for privatizing state-owned enterprise are credible and in many cases will improve the welfare of various interested parties. Some of the rationales for privatization are described below.

Efficiency: Evidence abounds that privatized enterprise offers greater efficiency and subsequently offers better use of scarce economic resources. (Bos: 352-360; Kay/Brittan: 18-38; Sexty, 1986). Employees may benefit from privatization, particularly when they are given ownership options (Game: 38-39; Isenstein: 61-64; Robinson: 16-35). Professional manager also benefit when they may become owners (Isenstein: 61-64 ; Kay/Brittan: 18-38). These two groups often lose in the privatization process, however, due to reductions in employment, rationalization of production processes or closing redundant facilities.

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Change in the political culture: Another effect of privatization is to change the political culture. Transforming the electorate into stockholding capitalists creates a different view of government intervention. The new capitalists are eager to receive dividend shares of enterprise they own, and as such favor political ideologies, and the new electorate is more likely to vote for conservative politicians seeking to shrink the size and role of government (Curry: 18-19).

Success of the enterprise: Another factor favorable to privatization is the success of the some government enterprise. Perhaps two of the bets examples are Conrail and Singapore Airlines. Both of these formerly state-owned enterprises were strong candidates for privatization simply because they had become very profitable, and had strong market value based on projections of their future earnings flow (Keslar: 93-97). As such, it could easily be argued private ownership was a better setting for these enterprises.

Some of state-owned enterprises had contributed mightily to these huge deficit (Borins; Laux: 38-41; Stewart-Patterson: B4). The costs simply became too great. Although the prior nationalization of these firms was politically popular, the mounting losses became unbearable. The social goals of enhancing national pride and maintaining significant levels of employment became secondary to economic-prudence and reducing a swelling federal deficit. Being adept managers, the political leadership recognized these prior losses as sunk costs. This created a new reality for the enterprise: write off the sunk costs, and seek to strike a politically acceptable bargain that would preserve as many of the social goals as possible, while financially structuring the sale of the company so it can survive as a private enterprise.

Technological competence: Many state-owned firms are unable to fund sufficient technological research, or technological modernization of production facilities. Selling the firms to the private sector facilitates needed capital investment or investment in research and development.

Reducing the size of government: Consistent with the conservative political agenda is a general interest in reducing the size of government. This objective has been core in many of the American efforts at privatization, and is also the case in other developed nations with conservative governments (Butler, 1985; Savas: 1987).

Improving customer service: Although improving customer service may not be a powerful stimulator of privatization, it appears to be a real justification in some cases, since consumers are nearly always better treated by privatized enterprises than during the period of public ownership (Herzberg: 63-70; Morley: 124-129).

These many rationales for privatization are overlapping and in some cases highly correlated. Nations engaged in privatization do not explicitly identify each rationale, and as such, interpretation of the context is offered. Some general themes emerge through this effort to understand rationales for transfer to private ownership.

Dilemmas

There are some significant dilemmas for the actors in the worldwide movement toward privatization. One is felt by the international funding agencies. These agencies generally want to encourage privatization, but are not accustomed to working with private enterprise. For decades these agencies have advocated centralized state economic planning and state ownership as the most expedient manner to foster development. Having learned to interact with government functionaries, these international lending agencies must now learn how to work with private firms and entrepreneurs.

Another dilemma is for governments committed to privatization. In deciding what state-owned enterprise to privatize, the governments are most interested indisposing of the enterprise that is unprofitable, inefficient, and a financial burden on the state. Yet these are the enterprises that are least suitable for commercialization, and are least appealing to investors. These firms must be privatized at very low prices to create a potential for economic viability as a private enterprise. The market price is often well below the asset value carried on the national accounts of the country. State-owned enterprises that are profitable and efficient are those the governments are least interested in privatizing, yet these are the firms that are most in demand in the private sector.

The Manner in Which The Firm Is Privatized

The manner in which the enterprise is privatized is significant. Factors include the financing to the privatization, the contractual constraints of the privatization, and the government's willingness to deal with the managerial issues involved.

Financing the privatization can be thought of in several ways. First is the amount of money the government wishes to capture in the privatization process. If the enterprise is struggling financially, by selling it at a low price the value of the firm is increased to the new owner, who can then afford to invest additional capital into ongoing operation. This can also be done in a way to eliminate burdensome debts, and to improve the operational margins of the continuing business. Below is public enterprise responsive model comparing market model and bureaucratic model.

Public Enterprise Responsiveness Model

Market Model	Bureaucratic Model
Financial integrity with emphasis on profitability.	Finances overlap with national budget. Losses accepted for social reason.
Clear commercial and social objectives.	Confusion about objectives and political interference in decisions.
Operating independence. Performance monitoring by outputs.	Close scrutiny of input decisions (employment, investment) and attention to politically sensitive output (prices). Lack of concern with overall enterprise efficiency.
Potential competition from domestic rivals and imports.	Tariff barriers and import licensing to limit competition. Legal restrictions prevent market entry by potential domestic competitors.

Source: Aylen, "Privatization in Developing Countries," 1987.

Another government decision in the financing of the privatization is to whom the business will be sold. Options a re many. They include selling the enterprise to interested parties the government may wish to protect the privatization process – for example, selling the business to the employees will do much more to protect their interests than selling it to a foreign multinational firm.

The contractual issues of the privatization involve the constraints the government places on the operations of the new firm. Often these constraints are needed to make the privatization acceptable to different stakeholders.

Managerial issues should be another major area of the government decision process. Here the unit of analysis is not the management of privatization process within the government, but a concern for the management of the newly privatized enterprise. Ineffective and politicized management is often a causal factor in making an enterprise a likely target for privatization (Boothman: 302-306; Smith & Smith: 70-74). The management during the years of government ownership may have learned to be more responsive to political implications of managerial decisions than economic or competitive implications. This often leads to inefficiencies, bloated payrolls, slow decision processes, and continuation of services and products that are not economically viable.

Frequently the sitting government administration either can not or will not address these problems due to the potential political costs of streamlining the management process. (Butler, 1985). The issue to be decided is whether to address this issue before privatization, which would have the effect of improving the marketability and value of the enterprise, or to ignore the issue and leave it for the new owners to address.

Management Of The Privatized Enterprise

This leads to the other critical area of concern: the management of the new enterprise. Perhaps the most important managerial questions is that of continuation or replacement of the present management team. An audit of the management team is an essential step in the privatization process. The managerial audit should investigate the flexibility, ability, and willingness of the management team to function in the new competitive environment.

The argument is not that the management team from the pre-privatization enterprise is unable to function in the environment. The argument is that these are important questions that need to be asked in the privatization process. They may be addressed prior to privatization, or after the transfer is complete. If the government seeks to address the managerial issues prior to privatization, the marketability and value of the enterprise will be improved by offering a more viable enterprise to potential buyers. If these questions are not addressed prior to privatization, they should be foremost of the important issues to be addressed by the new owners after privatization.

Only a few of the privatization efforts have addressed these issues. This is understandable, since they are not central to the public policy issues involved. They are, however, important to the survivability and economic viability of the newly privatized enterprise.

Conclusions

Privatization is a significant change in the existing pattern of enterprise ownership. The differences in privatization programs in the developed, recently developed and less developed nations is striking, as is the impact of third world debt and influence of the international funding agencies. Accepting privatization as a determined public policy, the task of management researches is to understand the managerial implications of the difference in-state ownership and privatized ownership.

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