# “Ineffective Privatization of Public Enterprises: The Case of Bangladesh Part I”


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# A Theory of Ineffective Privatization: The Case of Bangladesh – Part I[1]

Tanweer Akram[2]

**Abstract:** This paper puts forth a model of ineffective privatization, appropriate to the circumstances of developing countries, such as Bangladesh, and transitional countries, to illustrate that perverse outcomes of privatization might occur. Various types of privatization are classified in terms of social welfare.

**Keywords**: Privatization, Bangladesh, Debt Default
**JEL** L32, L33, G32, O53, P42

## Introduction

A model of ineffective privatization appropriate to the circumstances of developing countries is constructed in the first section of the paper. The second section gives a welfare-theoretic typology of various types of privatization, following Bhagwati's (1982) seminal paper. It is pointed out that in order to ensure that privatization increases social welfare, the authorities must satisfy a host of conditions. The third section concludes by discussing policy implications.

The main theoretical argument of this paper is illustrated with the example of Bangladesh. Among developing countries Bangladesh is one of the pioneers in the privatization of public enterprises. As against the transitional countries it has undertaken one of the most extensive privatization programs. The ineffectiveness of the program has been the subject of several studies, such as Sen (1997) and Akram (2001). The floundering experience of privatization of Bangladesh leads itself to a model of ineffective privatization. In contrast to Boycko *et al* (1996), this model reveals that perverse post-privatization outcomes are possible because the firm retains a soft-budget constraint even after privatization.

## 1. A Model of Ineffective Privatization

In many developing economies, including Bangladesh, privatization has been unable to deliver the promised benefits. Firms borrow from state-owned Nationalized Commercial Banks (NCBs) and Development Financial Institutions (DFIs) for financing deficits, for investment in new plants and equipment and for working capital, but fail to repay the state banks. Privatized enterprises, also, continue to rely on financing from state-owned banks. For the authorities the political cost of financing privatized enterprises, as measured by the politician's opportunity cost of handing over public funds to privatized enterprises, need not necessarily be less than the political cost of financing public enterprises, as measured by the politician's opportunity cost of handing over public funds to public enterprises. In a society where vertical ties are much stronger than horizontal ties, the authorities can benefit substantially from financing private and privatized enterprises. Even after privatization the authorities may connive with the management of the privatized enterprises to secure more loan capital than the socially optimal level. The case of Bangladesh suggests that privatization may not decrease state-directed credit and the volume of financing in a regime with weak institutions and bad governance. The authorities' cost of financing of a private firm may not be greater than the cost of financing of public activity. A simple model below demonstrates that after privatization the volume of misdirected credit might not be decreased. Non-

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performing loans, misallocation of resources, inefficiency, and sub-optimum outcomes can still prevail and render privatization ineffective.

### *Incomplete Privatization*

There are two players: the authorities and the manager of the firm. Suppose the share of the private ownership of the firm is $\alpha \in (0,1)$. As $\alpha \to 0$, the firm is under state ownership; as $\alpha \to 1$, the firm is under private ownership. Here $\alpha$ can be interpreted in two alternative ways. In "micro" terms, it is the private sector's share of a particular firm. Alternatively, in "macro" terms, it is the share of firms in the private sector. Correspondingly, $(1-\alpha)$ is the public sector's share of a particular firm, or public sector's share out of the total number of firms. Here, the "micro" interpretation is more natural. Privatization is simply the increase of $\alpha$, that is, the transfer of ownership such that the control of the firm's managerial decisions passes from the state to the private sector. However, the state either owns or controls the banks that are responsible for financing.

It can be useful to categorize privatization into two types: (a) complete privatization and (b) incomplete privatization. Complete privatization occurs when not only almost all productive enterprises but also the financial sector is dominated by privately owned entities, whereas incomplete privatization occurs when some productive enterprises have been privatized but the financial sector is still dominated by state-controlled entities. In many developing and transitional countries, privatization is incomplete. It may be years before developing and transition countries achieve complete privatization. Complete privatization is difficult to attain. Moreover, the authorities may want to retain control of the banking system. As Table 1 below shows, in many transition economies undergoing privatization, the liberalization and the privatization of financial institutions lag behind the privatization of industrial enterprises and commercial ventures. This delay of the process of privatization, which results in incomplete privatization, reflects the actual experience of many developing and transitional economies.

Table 1

Progress in Transition: Incomplete Privatization & Reform in Banking Sector

| Country | Private Sector Share of GDP | Large-scale Privatization | Small-scale Privatization | Price Liberalization | Banking Reform, Interest Rate Liberalization |
|---|---|---|---|---|---|
| Albania | 75 | 2 | 4 | 3 | 2 |
| Armenia | 60 | 3 | 3 | 3 | 2+ |
| Azerbaijan | 45 | 2 | 3 | 3 | 2 |
| Belarus | 20 | 1 | 2 | 2 | 1 |
| Bulgaria | 50 | 3 | 3 | 3 | 3- |
| Croatia | 55 | 3 | 4+ | 3 | 3- |
| Czech Republic | 75 | 4 | 4+ | 3 | 3 |
| Estonia | 70 | 4 | 4+ | 3 | 3+ |
| Georgia | 60 | 3+ | 4 | 3 | 2+ |
| Hungary | 80 | 4 | 4+ | 3+ | 4 |
| Kazakhstan | 55 | 3 | 4 | 3 | 2+ |
| Kyrgyz Republic | 60 | 3 | 4 | 3 | 3- |
| Latvia | 60 | 3 | 4 | 3 | 3- |

Table 1 (continuous)

| | | | | | |
|---|---|---|---|---|---|
| Lithuania | 70 | 3 | 4 | 3 | 3 |
| Moldova | 45 | 3 | 3+ | 3 | 2+ |
| Poland | 65 | 3+ | 4+ | 3+ | 3+ |
| Romania | 60 | 3- | 3+ | 3 | 2+ |
| Russian Federation | 70 | 3+ | 4 | 3- | 2 |
| Slovak Republic | 75 | 4 | 4+ | 3 | 3- |
| Tajikistan | 30 | 2 | 2+ | 3 | 1 |
| Turkmenistan | 25 | 2- | 2 | 2 | 1 |
| Ukraine | 55 | 2+ | 3+ | 3 | 2 |
| Uzbekistan | 45 | 3- | 3 | 2 | 2- |

### *Hard and Soft Regimes*

It is useful to draw a distinction between a hard regime and a soft one. Under a hard regime the authorities formulate, implement, and enforces rules of the game that adhere to tight budget constraints and prudential regulations without make exceptions. Under a soft regime the authorities are susceptible to influence by lobby groups and pressure from the managers of firms whether publicly or privately owned. Hence, the authorities relax firm's budget constraint by financing deficits and capital investments from the exchequer's funds. Another way of viewing the difference between a hard regime and a soft one is to note that whereas the former has the ability and the political will to enforce contracts the latter is often unable to do so.

### *Preferences*

The level of financing for the firm is D. The levels of loan are restricted to two, $D=\{D_L,D_H\}$, where $D_H>D_L>0$. The difference between the high and the low levels of financing is $\Delta D=D_H-D_L$. $D=\alpha D+(1-\alpha)D$.

The authorities and the manager have preferences over the level of loan. Let the state authorities' utility function be $U_a= -\rho(1-\alpha)D$. For state authorities the cost of an extra dollar of loan is $\rho$. The authorities have alternative and better use of loan. They can either spend the money on goods that benefit them directly or spend it on projects that increase their likelihood of being re-elected. For instance, the authorities can build presidential palaces, give employment subsidies, fund the army, construct tunnels that lead nowhere, erect useless dams, or run food for work programs not to alleviate poverty but to secure votes, etc.

The firm manager's utility function is $Um=\mu D-\alpha\lambda D$ where D is the level of loan, $\mu$ is the benefit of the loan, and $\lambda$ is the cost of the loan. The benefit of an extra dollar of loan is $\mu<1$. However, an extra dollar of loan reduces the value of the firm's profit because the shareholders may rebuke her for incurring costs and losing money. But she does not directly worry about the firm's foregone profits as a result of high loan. The cost to the manager as a result of loan accumulation per dollar is $\lambda<1$ because she cares less about the firm's profit than obtaining bank loans. The higher amount of loan can be used for over-invoicing, capital flights, conspicuous consumption, empire building, etc. The rate of interest can be below the market rate of interest. The state banks are unlikely to press for bankruptcy if the firm fails to repay. State banks care little about their asset quality in a regime without much financial discipline. This is quite typical of the kind of "crony" capitalism of many developing countries. Under such a regime the manager does not worry about the foregone social cost of state loans. If the manager borrows at a subsidized interest rate, if the conditions for servicing the loan are flexible and can be re-negotiated, or if there is some possibility of loan-forgiveness or re-capitalization by the state, it is natural to stipulate that $\lambda<1$. The collateral used as a mortgage for obtaining the loan can be of dubious value. As long as

the authorities are not fully credible as loan collectors, or the credit collection mechanism is weak and ineffective, the manager's cost of an extra dollar of loan is less than a dollar of loan. $\lambda<1$ creates a bias for a high level of loans if the manager chooses the level of loan. The manager's cost of extra dollar of loan is $\alpha\lambda$.

The authorities will set $D=D_L$, whereas the management will set $D=D_H$. The authorities will choose $D_L$ because they have alternative and more rewarding uses for funds. The manager will choose $D_H$, because she tries to get as high loan from state-owned banks as possible.

### *Public Enterprise Regime under a "Soft" Regime*

When the firm is under a public enterprise regime, the firm's manager determines the level of loan. Thanks to the entrenched power of the line Ministry in charge of the public enterprise and the manager of the public enterprise, the Ministry of Finance accepts the request for financing and instructs the state-owned financial institutions to readily oblige, even though it would prefer lower financing. Akram (2002) documents that the overall financing needs of public enterprises in Bangladesh are met by a combination of net long-term borrowings and equity injections financed by the authorities and by public enterprises' finance deficits. He shows that the authorities have failed to impose tight budget constraints on public enterprises despite their chronic losses and consistency of poor performance over many years.

The softness of budget constraint is often the case for public enterprises in developing economies with poor financial sector discipline and inept public sector management. Thus, despite the inherent problems of the financing scheme, the Ministry of Finance complies with the manager's request for continued funding. Thus, if the manager controls loan, she chooses $D=D_H$. It is stipulated that

$$\mu > \alpha\lambda(A) \tag{1}$$

Specification (A) states that the manager's own benefit from the higher loan exceeds its cost of per dollar of profits foregone by the firm from such borrowing. The manager's control of loan leads to a higher level of debt at public expense. This demonstrates the effect of lax financial discipline on the manager's behavior. Over-borrowing leads to a higher level of loans at the expense of the state, the public, and other shareholders.

### *Performance Contracts: A Dismal Remedy*

The authorities may "bribe" or offer some "gift" to induce the manager to set $D=D_L$. "Bribe" or "gift" here is some form of side payment, without any implication about its legality. Assuming transferable utility functions, the authorities pay some amount, $\Pi$, to have the manager borrow at the lower level. In essence $\Pi$ is the side payment under an incentive scheme or performance contract that the authorities offer to secure an outcome with lower debt.

The utility functions of the authorities and the manager are as follows:

$$U_a = -\rho(1-\alpha)D - \prod \tag{2}$$

$$U_m = \mu D - \alpha\lambda D + \prod \tag{3}$$

The manager chooses the lower loan, $D_L$, if the combined utility is greater with the lower loan, $D_L$, than the combined utility with the higher loan, $D_H$. For the performance contract to work the following must hold:

$$\rho(1-\alpha) + \alpha\lambda > \mu(B) \tag{4}$$

When (B) holds, the outcome with lower debt is realized. In (B) the left-hand side is the sum of the authorities' and the manager's benefit of lower debt and the right-hand side is the manager's cost of lower debt. If the sum of the authorities' and the manager's benefit of lower debt is greater than the manager's cost of lower debt, an incentive scheme can lower the level of debt. Thus, with the incentive scheme it is possible for the authorities to "buy" a lower level of loan.

(A) and (B) can be satisfied at the same time. However, if $\rho(1-\alpha)+\alpha\lambda \leq \mu$, that is, the sum of the authorities' and the manger's benefit of lower debt is less than the manager's cost of lower debt, the outcome with a lower level of debt is not realized.

The use of an incentive scheme, such as a transfer of $\Pi$, is problematic because of the unenforceable nature of contracts in the public sector under a "soft" regime. Nellis (1989) shows that performance contracts in several African countries have been unable to overcome the problems of public enterprises and do not improve their financial performance. Shirley and Xu (1998a) analyze China's experience with performance contracts in more than 400 public enterprises. The Chinese authorities put considerable effort in seriously designing and implementing performance contracts to reform public enterprises and raise their performance. However, they find that performance contracts do not improve productivity, performance or growth in China's public enterprises. There appears to be no connection between the variables for commitment and the effects of the performance contract. They report that these contracts may be detrimental if they provide only weak incentives and do not reduce information asymmetry. In another paper Shirley and Xu (1998b) examine 12 performance contracts in six developing countries (Ghana, India, Mexico, the Philippines, Senegal and South Korea). They find that only three of the 12 case-study firms showed an improvement in total factor productivity after contracts were introduced, whereas six continued past trends, and three performed substantially worse. They report that performance contracts do not enable developing countries' authorities to address the problems of information asymmetry, incentives, and commitment. These studies confirm that instances of successful application of performance contracts to improve public enterprises in developing countries are rare. In "soft" regimes, the manager would choose $D_H$ despite the incentive scheme, without fear of any reappraisal as long as she does not face any credible threat from the authorities.

### *Privatization Regime under a "Soft" Regime*

Does privatization improve anything? After privatization, the state authorities, rather than the firm management, approve loans. If the authorities set the level of loan, they would choose $D=D_L$. It may, thus, appear that after privatization the level of financing would decrease because the manager requires the authorities' approval to get loans from the state banks. However, she can then simply "buy" her way to a higher loan. The manager would be willing to give a "gift" to the authorities of a net amount M to get a higher level of loan, $D_H$, rather than $D_L$. The manager's cost for giving the "gift" is $\kappa M$. Here, $\kappa<1$ because "gift-giving" from a loan received is less expensive for the manager than paying from her own pocket. If the manager's cost of "gift-giving" is equal to paying from her own pocket, then $\kappa=1$.

For the manager there are two parameters representing foregone profits, $\lambda$ and $\kappa$. The first parameter, $\lambda$, measures the manager's cost of foregone firm profit and the second parameter, $\kappa$, measures the manager's cost of the "gift" to the authorities. If it is easier for the manager to lose the firm's profit than to make a sacrifice to the authorities by giving the "gift," then $\lambda<\kappa$; otherwise, $\lambda \geq \kappa$. It is assumed here that $\lambda<\kappa$.

With such payments the utility functions of the authorities and the manager are respectively as follows:

$$U_a = -\rho(1-\alpha)D + M \tag{5}$$

$$U_m = \mu D - \alpha\lambda D - \kappa M \tag{6}$$

The assumption about "gift-exchange" is not inappropriate in the case of developing countries, such as Bangladesh. Ahmad *et al* (1999) report widespread general perception of ram-

pant corruption in Bangladesh. According to Transparency International's (1996) well known and widely used corruption perception index, given in Table 2 below, businesspersons regard Bangladesh to be within one of the most corrupt countries in the world. Bangladesh's power sector is characterized by high system loss. System loss is the share of generated output lost in the transmission and distribution of electricity to the final consumer. High system loss, which includes non-technical losses due to theft and pilferage, is induced by bureaucratic corruption and connivance. In a recent survey (Transparency International 2002) 30 per cent of the household reduced the electricity bill by arrangement with the meter reader. Table 3 below shows system loss as indicated by the loss to generation ratio. The high level of system loss in electricity transmission in Bangladesh is symptomatic of the persistence and the ascendancy of unbridled corruption in the country.

Table 2

Transparency International Corruption Perception Index 1996

| Rank | Country | Score 1996 | Score 1995 | Variance | # Surveys Used |
|---|---|---|---|---|---|
| 1 | New Zeland | 9,43 | 9,55 | 0,39 | 6 |
| 2 | Denmark | 9,33 | 9,32 | 0,44 | 6 |
| 3 | Sweden | 9,08 | 8,87 | 0,30 | 6 |
| 4 | Finland | 9,05 | 9,12 | 0,23 | 6 |
| 5 | Canada | 8,96 | 8,87 | 0,15 | 6 |
| 6 | Norway | 8,87 | 8,61 | 0,20 | 6 |
| 7 | Singapore | 8,80 | 9,26 | 2,36 | 10 |
| 8 | Switzerland | 8,76 | 8,76 | 0,24 | 6 |
| 9 | The Netherlands | 8,71 | 8,96 | 0,25 | 6 |
| 10 | Australia | 8,60 | 8,80 | 0,48 | 6 |
| 11 | Ireland | 8,45 | 8,57 | 0,44 | 6 |
| 12 | UK | 8,44 | 8,57 | 0,25 | 7 |
| 13 | Germany | 8,27 | 8,14 | 0,53 | 6 |
| 14 | Israel | 7,71 | na | 1,41 | 5 |
| 15 | USA | 7,66 | 7,79 | 0,19 | 7 |
| 16 | Austria | 7,59 | 7,13 | 0,41 | 6 |
| 17 | Japan | 7,05 | 6,72 | 2,61 | 9 |
| 18 | Hong Kong | 7,01 | 7,12 | 1,79 | 9 |
| 19 | France | 6,96 | 7,00 | 1,58 | 6 |
| 20 | Belgium | 6,84 | 6,85 | 1,41 | 6 |
| 21 | Chile | 6,80 | 7,94 | 2,53 | 7 |
| 22 | Portugal | 6,53 | 5,56 | 1,17 | 6 |
| 23 | South Africa | 5,68 | 5,62 | 3,30 | 6 |
| 24 | Poland | 5,57 | na | 3,63 | 4 |
| 25 | Czech Republic | 5,37 | na | 2,11 | 4 |
| 26 | Malaysia | 5,32 | 5,28 | 0,13 | 9 |
| 27 | South Korea | 5,02 | 4,29 | 2,30 | 9 |
| 28 | Greece | 5,01 | 4,04 | 3,37 | 6 |
| 29 | Taiwan | 4,98 | 5,08 | 0,87 | 9 |
| 30 | Jordan | 4,89 | na | 0,17 | 4 |

Table 2 (continuous)

| | | | | | |
|---|---|---|---|---|---|
| 31 | Hungary | 4,86 | 4,12 | 2,19 | 6 |
| 32 | Spain | 4,31 | 4,35 | 2,48 | 6 |
| 33 | Turkey | 3,54 | 4,10 | 0,30 | 6 |
| 34 | Italy | 3,42 | 2,99 | 4,78 | 6 |
| 35 | Argentina | 3,41 | 5,24 | 0,54 | 6 |
| 36 | Bolivia | 3,40 | na | 0,64 | 4 |
| 37 | Thailand | 3,33 | 2,79 | 1,24 | 10 |
| 38 | Mexico | 3,30 | 3,18 | 0,22 | 7 |
| 39 | Ecuador | 3,19 | na | 0,42 | 4 |
| 40 | Brazil | 2,96 | 2,70 | 1,07 | 7 |
| 41 | Egypt | 2,84 | na | 6,64 | 4 |
| 42 | Columbia | 2,73 | 3,44 | 2,41 | 6 |
| 43 | Uganda | 2,71 | na | 8,72 | 4 |
| 44 | Philippines | 2,69 | 2,77 | 0,49 | 8 |
| 45 | Indonesia | 2,65 | 1,94 | 0,95 | 10 |
| 46 | India | 2,63 | 2,78 | 0,12 | 9 |
| 47 | Russia | 2,58 | na | 0,94 | 5 |
| 48 | Venezula | 2,50 | 2,66 | 0,40 | 7 |
| 49 | Cameroon | 2,46 | na | 2,98 | 4 |
| 50 | China | 2,43 | 2,16 | 0,52 | 9 |
| **51** | **Bangladesh** | **2,29** | na | **1,57** | **4** |
| 52 | Kenya | 2,21 | na | 3,69 | 4 |
| 53 | Pakistan | 1,00 | 2,25 | 2,52 | 5 |
| 54 | Nigeria | 0,69 | na | 6,37 | 4 |

Source: Transparency International (1996)

Table 3

Electricity "System Loss" in Bangladesh

| Year | Electricity Generation | System Loss | Loss/Generation |
|---|---|---|---|
| | *In millions of kilowatt hours* | | *In percent* |
| 1991-92 | 8 894 | 2 873 | 32,3 |
| 1992-93 | 9 204 | 2 298 | 25,0 |
| 1993-94 | 9 784 | 2 337 | 23,9 |
| 1994-95 | 10 806 | 2 435 | 22,5 |
| 1995-96 | 11 474 | 2 478 | 21,6 |
| 1996-97 | 11 858 | 2 411 | 20,3 |
| 1997-98 | 13 572 | 2 592 | 19,1 |

Source: Bangladesh Power Development Board

## *"Gift-Exchange" and Nash-Bargaining*

The authorities and the privatized firm engage in bargaining to set M. The bargaining concept used here is that of Nash (1950 and 1953). The conventional assumptions applicable to Nash bargaining setup hold. The application of bargaining in illicit "gift-exchange" is apt because

it is precisely in such circumstances of splitting up public funds among politicians and managers of firms that agents pursue their self-interest over all other aspects of their nature. Nash bargaining is a suitable and applicable concept because it is free of specific institutional features. It also underscores the different outcomes with and without "gift-exchange."

Incremental utilities of switching from $D_L$ to $D_H$, for the authorities and the manager respectively, are as follows:

$$\Delta U_a = -\rho(1-\alpha)\Delta D + M \tag{7}$$

$$\Delta U_m = \mu\Delta D - \alpha\lambda\Delta D - \kappa M \tag{8}$$

The optimal "gift" level, $M^*$, is as follows,

$M^* = 1/2(\Delta D)\{[\kappa\rho(1-\alpha) + \mu - \alpha\lambda]/\kappa\} > 0$.

$\partial M^*/\partial\Delta D = 1/2\{[\kappa\rho(1-\alpha) + \mu - \alpha\lambda]/\kappa\} > 0$; the amount of "gift" increases as the difference between the high and the low level of loan capital increases.

$\partial M^*/\partial\rho = 1/2[(\Delta D)(1-\alpha)] > 0$; the higher the authorities' cost, the higher the level of "gift."

$\partial M^*/\partial\mu = 1/2\{[\Delta D]/\kappa\} > 0$; the higher the manager's benefit from the loan, the higher the level of "gift."

$\partial M^*/\partial\lambda = -1/2\{[(\Delta D)\alpha]/\kappa\} < 0$; the higher the manager's cost of foregoing firm profits, the lower the level of "gift."

$\partial M^*/\partial\kappa = -1/2\{[(\Delta D)(\mu - \alpha\lambda)]/\kappa^2\} < 0$; the higher the manager's cost of "gift," the lower the amount of "gift."

$\partial M^*/\partial\alpha = -1/2\{[(\Delta D)(\kappa\rho + \lambda)]/\kappa\} < 0$; as the private sector's share of the firm increases, the amount of "gift" becomes lower.

Plugging in the value of $M^*$ yields the following inequalities:

$$\kappa\rho(1-\alpha) + \alpha\lambda > \mu(C) \tag{9}$$

$$\kappa\rho(1-\alpha) + \alpha\lambda \le \mu(D) \tag{10}$$

In (C) and (D), the left-hand side is the sum of the authorities' marginal cost of higher loan, adjusted by the cost of "gift," and the manager's marginal cost of foregoing firm profits; the right-hand side is the manager's marginal benefit of higher loan. There is no bargaining if either party or both parties are worse off with $D=D_H$ and "gift" payment. (C) implies that if the sum of the authorities' marginal cost of higher loan, adjusted by the "gift" parameter, and the manager's marginal cost of foregoing firm profits, is greater than the manager's marginal benefit of the higher loan, the "gift" payment will not secure the higher loan. It can be called the *no "gift-exchange" inequality*. If this inequality holds, privatization works because it reduces the volume of state loans to the privatized firms. (D) implies that if the sum of the authorities' marginal cost of higher loan, adjusted by the "gift" parameter, and the manager's marginal cost of foregoing firm profit, is less than or equal to the manager's marginal benefit of higher loan, the "gift" payment will secure the higher loan. It can be called the *ineffective privatization inequality*. If (D) holds, privatization fails to bring about any effective change and reproduces continued state-directed credit to firms. In developing and transitional economies, it is possible that (D), rather than (C), holds. The ineffective privatization condition can prevail over the no "gift-exchange" condition.

In a "soft" regime the higher the authorities' reservation "gift" payment, the more likely is an efficient outcome. The authorities with higher reservation bribe will demand a bribe payment

that is too expensive for the manager. As a result, she will not pay. Hence, the authorities will refuse to sanction a higher loan, which results in a socially optimum outcome. The lower the authorities' reservation "gift" payment, the less likely is an outcome with lower debt. The authorities with lower "gift" reservation will demand a "gift" that the manager can afford. As a result, the manager will agree to pay. Thus, the authorities will approve a higher loan, which results in a socially suboptimum outcome.

Comparing (D) to (A) shows that (D) has the term $\kappa\rho(1-\alpha)$ which is the authorities' marginal cost of sanctioning higher loans adjusted by the gift parameter. Comparing (D) to (B) shows that (D) has the term $\kappa\rho(1-\alpha)$ while (B) has the term $\rho(1-\alpha)$. Since $\kappa<1$, therefore $\kappa\rho(1-\alpha)<\rho(1-\alpha)$. Thus, (D) may hold when (B) does not. But if $\kappa=1$, then (B) and (C) are of the same inequality.

### *Interpretation*

The results of the model are applicable in a regime of poor financial discipline and "soft" governance, conditions typical of many developing economies, such as Bangladesh. In many developing economies the ownership of the manufacturing firm is a mean for acquiring state financing and politically directed credit, access to hard currency, import permits, licenses, quotas, etc. Hence, when the state institutes "reforms," such as incomplete privatization, there may not be any substantial improvement of the performance of firms. There may be no change in a firm's behavior. An exacerbation of perversity cannot be ruled out. Far from driving a wedge between the firm and the state bureaucrat, such privatization may encourage asset stripping, corruption, lobbying, and nepotism. If the private manager has the authorities in her pockets or payroll, the volume of directed credit might not subside and, as a result, resources can still be misdirected and misallocated. Hence, the level of public financing may not fall after privatization. The unimpressive loan-repayment profile of privatized firms in Bangladesh (Akram, 2001) would seem to vindicate a theory of ineffective privatization and the persistence of *rentier* industrial firms. The model of ineffective privatization can be a reasonable account of the outcome of reforms if the financial system is dominated or monopolized by state-owed banks, if regulations are deficient and lax, or if the state sets interest rates and directs credit. A large number of reforms, including privatization, often fail to alter the fundamental institutional structures that perpetuate inefficiency.

## 2. A Welfare Theoretic Framework for Analyzing Privatization

Following Bhagwati's (1982) analysis of *rentier* activities, it can be argued here that privatization is not invariably welfare-enhancing. Although there is welfare gains that private ownership may bring about, privatization can also be accompanied by the following phenomena which may undermine and can often offset, partially or completely, such gains:

- Under-valuation of the net worth of the firm
- Tax evasion and avoidance
- Publicly leveraged buyouts of privatized firms
- Subsidized credit for the operation of privatized enterprises
- Exploitation of market power
- Protectionism
- "Insider" loans and trading
- Asset stripping and "tunneling"

All of these activities are classic examples of profitable *rentier* activities for the private agent who is not directly productive. By engaging in the above-mentioned activities, the private agent may earn economic incomes, using real resources, without contributing to output that enters the social welfare function or the social utility function. An example of such *rentier* activities in Bangladesh is the widespread tax non-registration following privatization (Akram, 1999). Since firms are not being forced to repay money owed to public commercial banks, loans to defaulter firms are *de facto* transfers of public funds to private agents. Mallon and Stern (1991) observe that business groups in Bangladesh place greater emphasis on perpetuating existing privileges than on lobbying for deregulation and liberalization.

An economy can be described as distortion-free if it is operating on the efficient transformation curve and as distorted if it is not operating on the efficient transformation curve. The following list provides typography, inspired by Bhagwati (1982), for analyzing the welfare consequences of privatization, considering the possibility of *rentier* activities of agents in the economy.

Table 4

Welfare Consequences of Privatization

| Case | Before Privatization | After Privatization | Welfare Consequences |
|---|---|---|---|
| I | Distorted | Distorted | No Unambiguous Results |
| II | Distorted | Distortion Free | Welfare-Enhancing |
| III | Distortion Free | Distorted | Welfare-Reducing |
| IV | Distortion Free | Distortion Free | No Unambiguous Results |

If prior to privatization the economy is distorted but remains so even after privatization, it is unclear whether there are any welfare gains (**Case I**). If the economy is distorted before privatization, but becomes distortion-free after privatization, then privatization is welfare-enhancing (**Case II**). If the economy is distortion-free, but becomes distorted after privatization, then there is welfare loss (**Case III**). If a distortion-free economy after privatization remains distortion-free then the welfare consequences are ambiguous (**Case IV**). Although privatization may cause the management of the firms to try to maximize profits, privatization may be coupled with increased *rentier* activities, which paradoxically can lead to welfare-reducing outcomes.

Privatization is welfare-improving only if some conditions are fully satisfied. Privatization schemes can be classified from the viewpoint of social welfare into the following categories: (i) *Welfare-enhancing privatization*; (ii) *welfare-neutral privatization*; and, (iii) *welfare-reducing privatization*. Privatization does not necessarily imply welfare gains. The welfare effect of privatization is essentially an *empirical* question, contingent on institutions, policies, organizational behavior, incentives, and moral and social relations of production and power.

## 3. Conclusion and Policy Implications

Privatization was and still is a part of the "Washington Consensus" program of market-oriented policy reforms advocated by the US Treasury and the Bretton Woods Institutions. Since the 1980s there has been a ongoing movement towards the privatization of public enterprises. The fall of "actually existing communism" further reinforced this movement. But the transition of the former socialist countries did not proceed in the way that conventional wisdom predicted. Privatization did not deliver the promised benefits even after a decade of transition (Stiglitz, 1999 and 2001). While privatization can bring about benefits under certain conditions, transfer of ownership is by no means a *sufficient condition* for improved performance of firms and setting off economic growth. Perverse outcomes of privatization leading to the perpetuation of soft-budget constraints and to nefarious asset stripping might occur under a soft regime in the absence of robust market institutions, contract enforcement, and prudential regulations. The experience of many developing countries and transitional countries lend credence to the view that such outcomes cannot be ruled out.

Privatization must be accompanied by a host of policy measures to ensure success. Policies ensure that privatization improves social welfare and include the following: proper valuation and assessment; financial sector discipline; enforcement of bankruptcy laws; effective tax administration; elimination of tax breaks, tax loopholes, discretionary concessions, and subsidies; regulation of monopolies and the capital market; and, finally, trade liberalization and openness, which promote market discipline, competition, better corporate governance, and public accountability. Developing appropriate market institutions and incorruptible public administration that prevent regulatory capture is a quite central task for the successful privatization and private sector devel-

opment. Discipline and prudential regulations in the financial sector can help to prevent the continuation of state directed credit to funds, which often lead to misallocation of resources. It is important to develop the building block of a market economy for effective privatization.

The overall improvement of the investment climate and the establishment of prudential rules of the game are necessary for raising the efficiency and the total factor productivity of firms and for creating the conditions for capital accumulation, knowledge diffusion, technological upgrading, and economic growth.

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