The Public Sector and Privatization.

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The public sector has been used for different purposes in different contexts. This has ranged from being an instrument for learning and technology absorption (with greater or lesser success) as in Taiwan and Malaysia, to an instrument for job creation and political stabilization. Even in some of the relatively successful cases like Malaysia, both functions have sometimes been combined.

The effectiveness of public sector management has often been studied using principal-agent models, and presented as an information and incentive problem. However, the great variance in public sector performance suggests that we also need to look at the political constitution of the state. The example of the East Asian newly industrializing countries suggests that countries where the state has effective powers to regulate have relatively well working public sectors, but their private sectors also work well. Conversely, countries where the public sector performs very poorly also have poorly working private sectors. This observation is not surprising in one sense, but it has important policy implications. However, the incentive and information issues are also important, but an excessive focus on these problems can cloud more important problems that have to do with political failures of regulation.

Instead of looking at the performance of the public sector in successful countries, we can get a different set of insights by looking at the public sector and privatization strategies in a more typical developing country, Bangladesh, which went through a massive privatization programme from the mid 80s onwards. In the early seventies Bangladesh went through a period of populism which saw more than 90% of large-scale industry being nationalized. The main impact of this nationalization was largely employment generation, and the beneficiaries were mostly middle and lower-middle class supporters of the regime, though blue-collar workers also benefited to a lesser extent. From the late seventies, under military regimes, a process of privatization was begun, and this accelerated dramatically in the early eighties. Before the collapse of the Eastern bloc, Bangladesh was the largest privatization experience.

The operation of the public sector and its subsequent performance after privatization gives us important insights into the nature of the problem facing industrialization strategies in poor countries. I collected data on the jute industry during my PhD and subsequently have worked on this industry. Jute is a natural product that makes a coarse fabric used in sacking, carpets and wall coverings. It has low value-added, but with investment, it could move into higher value-added products that could capture the environmental-friendly market that has been developing over the last few decades. In Bangladesh, however, the jute industry has been stuck in the low end of the product line, and the example of privatization shows the limitations of this approach for addressing the important issues of technology acquisition and learning.

The jute industry is interesting because while all of it was nationalized in 1972, in 1982 half of the mills that had previously been owned by Bengalis were privatized, leaving the rest in public ownership. This created a unique opportunity to observe the relative performance of the two sectors over time, and I have been doing this for the last two decades in an ongoing research project.

The story can be broken into three periods. In all three periods, the major effect of privatization, and indeed the exclusive focus of policy-makers, was on employment rather than on technological improvements, and this has a significant effect on the outcomes observed.

The first period that we looked at was 1983-1988. The results were used in my PhD dissertation and some of it was later published in the AER as a joint paper. The immediate impact of privatization was indeed on employment because the primary purpose of nationalization in 1972 was indeed to create jobs for key constituencies of the regime. With privatization, the new private owners had the incentive to dispose of excess labour, and a military regime provided cover for this strategy. As we expected, the major losers were white collar workers, because excess employment had been greatest in this sector. Manual workers did not suffer an equivalent loss in jobs but they suffered a loss in conditions as many were converted from permanent to casual status, with lower pay and little employment protection.

By the end of this period, the newly privatized mills had shed largely white collar workers, and relative to them, the public sector maintained excess employment to the tune of 30% for the white collar category. But the private sector did not shed a significant number of blue-collar workers suggesting that excess employment was not so significant for this category.

The story becomes even more interesting in the next period that covers 1988-94. During this period output of jute manufacturing contracted by around 20% as Bangladesh lost market share to India and other jute manufacturing countries and world demand remained stagnant. The World Bank became involved in a Jute Sector Restructuring Programme in Bangladesh, giving a loan to assist the reduction of subsidies to the sector. This was interpreted to mean further job reductions, which though they were important, diverted attention from the more difficult task of raising technology quality and moving up the product chain.

The result was that over 1988-94, the public sector followed the private sector in shedding white collar jobs. The excess employment in the white collar category declined over this period from around 30% to around 10%, while excess employment of manual workers virtually disappeared. Effectively, employment in the private sector served as a yardstick for public sector managers and for international agencies, and this information reduced the bargaining power of some key sections of employees in the public sector. This allowed attractive severance packages to be offered to white collar employees, and this resulted in rapid job reductions in the public sector.

The final period, 1994 to today shows the limitations of this strategy of privatization. The focus on employment ignored both wider issues of static efficiency, as well as the critical issue of technology and dynamic efficiency. On static efficiency, it ignored other forms of rent-capture other than excess employment. At the same time as the public sector responded to pressures for cutting white collar employment, the aggregate loss of the public sector relative to the private sector stayed constant despite the apparent reduction in excess employment. This suggests that other forms of rent-extraction continued and became stronger as excess employment of white-collar workers was reduced. This most likely took place through greater extractions by management and their political bosses.

Most critically, the reform process did not address the issue of technological upgrading and productivity growth through the production of upstream products. In this, Bangladesh possibly lost an opportunity to take the lead in using jute in the niche environmental markets that could support higher value-added products.

The effects of this began to become obvious in our last period. More than half of the private sector firms closed down despite their improvements in productivity due to labour shedding. Production shifted to India and other competitors of Bangladesh. The public sector lost its largest firm, the vast loss-making Adamjee Jute Mills.

The World Bank had not only ignored dynamic viability, it had ignored the political mechanisms through which the public sector had maintained its loss-making potential while losing labour, thereby being able to produce cheaper products than the private sector. In an unusual step, in 1996 the private sector appealed to the Inspection Panel of the World Bank to investigate the terms and the implementation of the Jute Sector Adjustment Credit. The Panel confirmed that despite claims to the contrary by the World Bank management, the private jute manufacturing sector had indeed suffered adversely and Bank management had not followed Bank policies in the design and implementation of the Credit. However, the Inspection Panel decided not to recommend any further investigation or remedy on the grounds that the loan period was almost over and a new loan was not envisaged.

This unhappy episode is unfortunately quite common in the privatization that is going on in developing countries. It identifies two key issues that are ultimately closely related. First, the reasons that public enterprises fail are closely connected to politics, and this failure has multiple manifestations even in terms of static inefficiency, not just excess employment. Second, the most important failure is in technology policy, which requires appropriate incentive and enforcement capacities on the part of the state, that in turn require appropriate political conditions for their implementation. For the state to have pushed the adoption of technological improvements in the jute sector would in the short term have required more subsidies not less, but also harsh enforcement conditions and penalties for non-performers. These capacities were not identified nor were the appropriate political conditions created simply through the privatization programme. I think these lessons have broader applicability in poorly performing developing countries where the reform of the public sector is high on the agenda.