CHAPTER 1

INTRODUCTION

1.1 Definition

Privatization has attracted much attention in recent years, and reflects a world-wide interest in reducing the role of the state in national economies.

In the broadest sense, privatization is a label for any expansion of the scope of private sector activity, or the assimilation by the public sector of efficiency - enhancing techniques generally employed by the private sector (Adam and Cavendish, 1991). According to Heald (1988), `privatization´ is an umbrella term for a diverse set of policies, albeit linked through an underlying judgement in favour of strengthening the `market´ at the expense of the `state´. Aylen (1987) regards privatization as a series of steps leading toward increased efficiency and the separation of a state enterprise from government bureaucracy. The establishment of an independent board, financial autonomy, and operating freedom are the first steps toward improved efficiency, while eventual private ownership is the final step. In its narrow sense, privatization is a transfer of ownership and control of assets from the public to the private sector (Adam and

Cavendish, 1991). Thus, privatization has taken many forms and guises, all of which reflect a political commitment to 'roll back the public sector' and to 'free market forces'.

1.2 Performance of Public Enterprises (PEs)/State-owned Enterprises (SOEs)

In the post-independence years, growing state domination of the economy was accepted of new governments. Enterprises owned by the government were involved in capital or technology intensive operations and also in areas considered essential to economic progress and national security, such as mining, petroleum production, railways, telecommunications, electricity supply, national airlines, national health and educational services, to name a few. State enterprises were sometimes created as export and import monopolies, to stabilize agricultural prices, to subsidize consumer prices or even to collect taxes. Politically, state enterprises were sometimes created to enhance the control over developing economies of post-independence regimes or the consolidation of ruling party's political power (Cowan, 1990).

Public enterprises (PEs)/state-owned enterprises (SOEs) have been considered important in both industrial as well as developing economies. In less developed countries (LDCs), the reliance on PEs to achieve socio-economic goals has been very great. For example, in some LDCs, PEs have accounted for between 40 and 60 percent of the gross domestic product (GDP).

In recent years, enterprises owned by the state have involved a staggering burden of costs for their governments. Many PEs are financial loss makers even with the concessions and special privileges they often enjoy. For example, state enterprises in most Asean states with the exception of Singapore have been inefficiently managed and operated. Huge losses incurred by state enterprises have in turn required huge budgetary outlays. According to Cowan (1990), the growing indebtedness of state-owned enterprises (SOEs) was due to several factors:

* Many governments were prone to use them for other purposes than those for which they were originally designed. Conflicting objectives - policy and financial - brought conflicting signals from the government so that management were often unable to determine what policies were required to meet their objectives.

* Inexperienced management were unable to operate the businesses profitably. The blame cannot be placed entirely on the management since government pricing and labour policies frequently made it impossible even for efficient managers to overcome social overhead costs

which the firms were required to bear. In many cases, managers were asked to produce results with firms that had been located - for political or regional development reasons - with little thought of proximity to markets or access to raw materials. Thus, national treasuries had to make up for the growing negative cash flows if the SOEs continued in business.

* Many governments also failed to develop effective means for monitoring the numbers and performance of the SOEs. They were often slow to realise the dangers posed by SOE indebtedness, which in many cases accounted for 20 to 40 percent of total domestic credit. Between 1976 and 1983, SOEs were responsible for US$80 billion of less developed countries (LDCs) debt (Cowan, 1990).

Reducing SOE deficits became a national priority for most countries - the solution was seen to be divestment or liquidation of money losers. Therefore, privatization was seen as the "only way" to bring the much needed income to the national treasuries of many governments.

1.2.1 Performance of Public Enterprises (PEs)/State-owned Enterprises (SOEs) in Malaysia

Malaysia, in early post-independence period (1957-69), essentially pursued a laissez-faire development strategy. Such a development strategy allowed the continued dominance of what were then the commanding heights of the

Malaysian economy, namely plantation agriculture, mining, banking, and manufacturing by foreign (particularly British) capital and, to a lesser extent, local (essentially Chinese) capital during this period (Toh, 1989). By the end of the sixties, Malay participation, including that of state agencies, in the modern sector of the Malaysian economy was glaringly low. By 1969, such inequalities precipitated a major racial riot.

The Malay elite-dominated Malaysian Government's New Economic Policy (NEP) was designed to achieve ethnic redistribution goals. The NEP, introduced in 1971, was committed to reduce poverty and inter-ethnic economic disparities in order to achieve national unity. One of the objectives of the government is to increase the corporate wealth ownership of the Bumiputeras to 30 percent by 1990. Thus, public enterprises - in the form of new statutory bodies, government corporations, government-owned or controlled publicly listed companies as well as government-owned or controlled private companies - became the means to achieve the government's objectives. Such government enterprises were involved in a wide range of economic activities: agriculture, manufacturing, transport, construction, finance and services. The heavy involvement of the state in the economy continued through the seventies till the early eighties.

Unfortunately, the financial performance of most Malaysian public enterprises has been very disappointing. Financial data reveals that nearly half of them incurred losses. Out of a total of 770 companies examined by the government, only 387 companies recorded profits, while 383 companies suffered losses. The profits of profitable companies were not enough to offset the losses of the loss-making companies. For example, while profits amounted to RM4.6 billion in 1988, losses were a staggering RM5.6 billion (see Table 1.1)

TABLE 1.1

PERFORMANCE OF GOVERNMENT COMPANIES
(RM Million)

Government Equity	Number of Companies	Accumulated Profits (RM)	Number of Companies	Accumulated Losses (RM)
20 - 30%	55	283	33	107
30 - 50%	70	377	47	392
Over 50%	262	4,208	303	5,111
Total	387	4,868	383	5,610

Source: Economic Report, 1988/1989, Ministry of Finance, Malaysia.

By the mid-1980s, the Malaysian government was facing a fiscal crisis. The Federal Government was experiencing a budget deficit even in its current account, with operating expenditure exceeding revenue from 1985. The hugh overall public sector budget deficit was due in part to the huge development expenditures incurred by the non-financial public enterprises (NFPEs), many of which incurred losses that constituted a drain on the financial resources of the state. This is due to the fact that as such public enterprises became larger in size, they became less answerable to external monitoring, let alone supervision. The NFPEs - previously known as off-budget agencies (OBAs) - have proved to be problematic, especially as they were not subject to federal and state budgetary constraints (Jomo, 1993). Therefore, confronted with a huge public sector budget deficit, the government had to put up with a huge public sector borrowing requirement (PSBR), that in turn led to the piling-up of public sector debt, especially the external debt. By the end of 1986, Malaysia's outstanding external debt was RM50.99 billion, of which about one-third was incurred by the NFPEs (Toh, 1989). The rapid accumulation of external debt led to a severe strain on the government's fiscal capacity and, as a result, there was a need for a new policy involving a dramatic reversal of the earlier expansion of the public sector, namely economic liberalization and privatization.

1.3 Privatization in International Perspective

The high costs and poor performance of SOEs in many countries have turned many governments toward privatization. The shift of development theory and ideologies in the face of mounting SOE losses, and the growing conviction that private entrepreneurs can manage industries more effectively and operate services more efficiently did not take place only in the industrial countries, but also in the LDCs. Between 1980 and 1992, more than 15,000 enterprises were privatized worldwide, more than 11,000 of these in the former East Germany (Kikeri, Nellis and Shirley, 1994).

The shining example of privatization has been provided by the Thatcher government of Great Britain. The Thatcher administration believed that privatization would bring about greater efficiency and consumer benefits. According to Clarke (1993), the different forms of privatization that have taken place in Britain include:

* Asset sales, which may involve denationalization, as in the case of British Gas, British Airways, and British Telecom, the sale of public sector companies earlier transferred from the private sector, such as Jaguar and Rolls Royce; or the sale of government holdings in private companies such as British Petroleum (BP).

* Deregulation, including the abandonment of state monopolies, which exposes public sector industries to competition as in the deregulation of bus and parcel delivery service.

* Contracting out work previously done in-house by direct labour, as in local government, the National Health Services (NHS) and the Civil Service.

* Private provision of services, allowing the private sector to provide services to the public, as in the case of nursing homes.

* Investment projects designed to encourage private sector involvement, as in projects in deprived areas, and special units in public sector organization devoted to commercial returns.

* The reduction of subsidies and the increased charges for public sector services such as health and welfare.

The acclaimed benefits of privatization by the Thatcher Government in the early 1980s influenced other countries in Europe and Asia to introduce similar reforms in the economy. By November 1986, French privatization was launched. Privatization projects included the state-owned deficit-running telecommunications company that supplied 16 percent of the public sector and 25 percent of private telecommunications equipment. Also, there were plans to sell French interests in television (Cowan, 1987). In Sweden, one of the strongholds of the welfare state, where the public sector budget amounted to a staggering 67 percent of GNP in 1982, market solutions have been given more attention in the 1980s although real privatizations are few. In both Australia and New Zealand, deregulation and privatization have also been significant.

In Asia, privatization as a special form of enterprise reform now occupies a central position in government efforts to develop the private sector. For example, China has allowed private farms to compete with state-owned cooperatives. In other Asian countries, from Japan to Sri Lanka, different types of privatization - to increase competition and efficiency in their economies - have also taken place. In Japan, the government has sold all or part of its stakes in Nippon Telegraph and Telephone (NTT), Japan National Railways (JNR), Japan Tobacco, and Japan Airlines (JAL). By April 1985, the monopolies of both the NTT and Japan Tobacco had come to an end. Since 1985, the government successfully sold its holdings in all four enterprises to the public (Naya, 1990).

In Sri Lanka, privatization has also made significant headway. Since 1987, several state-owned companies -including Ceylon Transport Board, Ceylon Shipping Corporation, and the Sri Lanka Cement Corporation - no longer enjoy monopoly positions in their respective industries. In 1988, the 26 year state monopoly in insurance also ended with the entry of three private sector companies into the insurance market (Naya, 1990).

In Korea, public enterprises played an important role in the government's development strategy in the 1960s and 1970s. Since the 1980s, Korea has also embarked on a privatization programme. In early 1988, the sale of stocks in Pohang Iron and Steel Company (POSCO) on the stock market marked the first sales of shares in public enterprises.

In the ASEAN (Association of South-east Asian Nations) region, the 1980s withnessed the withdrawal of state ownership and the introduction of privatization to renew emphasis on markets and competition. With the exception of Singapore, the state-owned enterprises of the other South-east Asian countries were incurring huge debts and were under pressure by international financial institutions - such as the International Monetary Fund (IMF) and World Bank - to privatize and deregulate, especially in countries such as Indonesia and the Philippines.

1.4. Privatization in Malaysia

According to the Privatization Masterplan (PMP), 'privatization' is defined as the transfer to the private sector of activities and functions which have traditionally rested with the public sector. In effecting such transfer, three essential organization-related components are involved, that is:

(i) management responsibility

(ii) assets (with or without liabilities), or the right to use assets

(iii) Personnel

In Malaysia, the privatization methods undertaken would entail the transfer of at least components (ii) and (iii) mentioned above.

Privatization in Malaysia can be implemented through several methods or a combination of the following methods:

1. Sale of Equity

This sale method involves government-owned companies and may result in the transfer of the three organization-related components mentioned earlier. Sale of equity can either be partial or complete. A complete sale involves a transfer of all government equity in a company while a partial sale involves the transfer of less than 100 percent. Examples are Tenaga Nasional (TNB), Cement Industries of Malaysia (CIMA), Sports Toto Malaysia Berhad, Malaysian Airline (MAS) and Malaysian International Shipping Corporation (MISC).

2. Sale of Assets

This mode of privatization involves government-owned assets. It may or may not involve the transfer of all the three organization-related components. Examples are quarries in Selangor, Perak and Pulau Pinang, and the Motel Desa Sdn. Bhd.

3. Lease of Assets

This involves the transfer of the right to use assets for a specified period in return for specified payments. The period depends on the nature of the project. It is usually applicable to the fixed assets of a candidate for privatization, particularly if the assets are large and it is strategic in nature such as seaports and airports. Lease rentals are based on future business prospects and not on the current value of the assets, and payments are calculated based on a stream of income and expenditure flows over the lease period. Examples include the Kelang Container Terminal Berhad and Malaysia Airports Berhad.

4. Management Contract

This method involves contracting private sector management expertise to manage government entities for a fee or commission. It entails the transfer of management responsibility, and may or may not involve transfer of personnel. It does not involve transfer of assets. One example here is the management of the water treatment plant at the Semenyih Dam.

5. Build-Operate-Transfer (BOT) and Build-Operate (BO)

BOT is relevant for privatizing new infrastructure projects such as roads and water supply projects. This method involves the private sector constructing the facility using its own funds, operating it for a concession period and then transferring it to the government. BO is similar to BOT, but does not involve the transfer of the facility to the government. Both BOT and BO will be accompanied by granting a licence and/or concession. Malaysian examples include the Jalan Kuching/Kepong Interchange, North/South Highway, the Second Link to Singapore (all BOT) and TV3(BO).

The Malaysian privatization policy was launched in 1983 with five objectives identified in the official 1985 Guidelines and further elaborated in the 1991 Privatization Masterplan (PMP). The official objectives of privatization are:

1. To relieve the financial and administrative burden of the government.

2. To improve efficiency and productivity. Efficiency will be promoted through the introduction of competition, freeing governmental organizations from political supervision and rigidities, and the introduction of new employee incentives.

3. To facilitate economic growth. With privatization, the economy is expected to be increasingly led by the private sector. With higher efficiency and profits, the government will be able to obtain additional revenue in the form of higher corporate taxes.

4. To reduce the role and size of the presence of the public sector in the economy.

5. To help in the achievement of national economic policy targets particularly with respect to restructuring the ownership pattern in the economy.

As of 1994, a total of ninety projects had been privatized since the launching of the policy in 1983. Sixty-nine were existing projects involving the private sector taking over government functions while the rest were new projects involving the construction of infrastructure and utility projects such as roads and water supply projects (Zainuddin, 1994). Table 1.2 provides the number of projects privatized and the modes of privatization used.

Advocates of privatization in Malaysia, including the PMP, have claimed that there has been tremendous success in its privatization policy. It has reduced the role of the public sector in the economy as well as the financial and administrative burden of the government. According to the

Ministry of Finance's 1993/94 Economic Report, the Federal government's financial burden was reduced in two ways:

(i) (potential) savings from new projects privately financed; and

(ii) proceeds from privatization.

TABLE 1.2

NUMBER OF PRIVATIZED PROJECTS
AS OF AUGUST 1993

Method	Number
BO	4
BOT	11
Lease	2
Management Contract	5
Sale of Equity	34
Sale of Assets	7
Management Buyout	2
Lease and Sale of Assets	3
Corporatization	9
Total	77

Source: Economic Report, 1993/1994, Ministry of Finance, Malaysia.

The Federal government was able to collect about RM2,063 million from divesting shares of privatized enterprises to the public (see Table 1.3). At the same time, recurrent revenue from privatization would come in the form of lease payments and also corporate taxes from privatized entities (Economic Report, 1993/1994). In terms of operating expenditure, the government has been able to save around RM4.8 billion from privatized projects. The main financial relief has come from savings on BOT projects as these represent the amount the government would have to provide as capital expenditure if the projects had not been privatized. The total estimated cost of BOT projects to date is about RM37.7 billion (Zainuddin, 1994).

TABLE 1.3

PROCEEDS FROM SALE OF EQUITY

	RM Million
Sports Toto Sdn. Bhd	113
Malaysia Airlines Berhad (MAS)	469
Malaysian Internationa Shipping Corporation (MISC)	90
Edaran Otomobil Nasional (EON)	29
Malaysian Shipyard and Engineering (MSE)	247
Perusahaan Padang Terap	51
Perusahaan Otomobil Nasional (PROTON)	177
Tenaga Nasional Berhad (TNB)	248
Telekom Malaysia Berhad (TMB)	639
Total	2,063

Source: Economic Report, 1993/1994, Ministry of Finance, Malaysia.

There have been clear indications that the objectives of efficiency and productivity have been achieved. For example, the licensing of private sector TV channels has introduced competition and thereby set new standards to the benefit of the viewing public. Another success comes from the privatization of the Kelang Container Terminal (KCT). Turnaround time was reduced from 11.7 hours to 8.7 hours within two years after privatization, while the average length of time each container remained in the dock declined from 8 days to 2.8 days. Privatization has reportedly reduced the government's administrative and financial burden significantly (Zainuddin, 1994).

Without doubt, privatization has led to economic growth. Such growth has been generated in a more direct manner through various BOT projects which encourage private sector entrepreneurs to invest in sectors previously the domain of the public sector.

In line with achieving national economic policy targets, all privatized projects have at least 30 percent Bumiputera participation. Also, the capital market has felt the impact of privatization. It had the effect of deepening and broadening the Malaysian stock market. As of July 1993, the 15 privatized companies constituted 25.4 percent of the total market capitalization of RM332 billion of the Kuala Lumpur Stock Exchange (KLSE), of which Telekom Malaysia

Berhad (TMB) and Tenaga Nasional Berhad (TNB) accounted for RM63.1 billion, or 19 percent of the total (Economic Report, 1993/1994).

While a string of successes may be highlighted by advocates of privatization in most of the countries mentioned earlier including Malaysia, a number of negative factors have been advanced by those who oppose the policy.

* Privatization has been promoted by governments, especially in the less developed countries (LDCs), to reduce the public sector deficits. In order to reduce the fiscal deficits, very often the most profitable enterprises are sold since they are the easiest to divest (Adam and Cavendish, 1991). Privatization in this sense may only postpone a fiscal crisis as the public sector would be stuck with a concentration of loss-making operations which require heavy subsidization.

* Privatization has been frequently undertaken under the banner of efficiency, effectiveness and improved services at lower cost. Unfortunately, for some consumers, the reality has been poorer quality goods and services at increased charges. This may be the result of cost-based pricing, the elimination of subsidization and economic rationalization (Woodward, 1986b). Privatization has also given priority to

profit-maximization, resulting in only profitable new services introduced rather than essential ones, which ultimately affects the poor and the needy.

* It has been argued that privatization could result in a greater concentration of economic power in the hands of the elites, therefore aggravating the wealth and income skewness in the country.

* One fundamental issue needed to be examined is the extent to which the domestic private sector can provide a competitive environment, through which economic efficiency gains can be expected to flow from privatization. Unfortunately, in most developing countries, the degree of competition afforded by the domestic private sector may be limited. Therefore, without the appropriate economic environment, privatization may not achieve the objective of productive and allocative efficiency.

Privatization in Malaysia has also given rise to a number of conflicting issues:

1. <u>Undervaluation of Assets</u>

One of the most controversial aspects of the privatization programme has been the pricing of the shares of companies offered for sale. Undervaluation of assets can be costly as it means that the government has received much less revenue from divestment than it could have. However, such underpricing may be a deliberate policy instrument to make `privatization through sale of equity´ a success. In Malaysia, the continuing desire to meet the ethnic wealth redistribution goals of the New Economic Policy (NEP) may lead to underpricing of shares with the hope of achieving wider share ownership.

2. Privatization and Efficiency

As an economic policy, privatization is based on the view that private ownership and control is more efficient in terms of resource allocation, compared to public ownership. At the same time, it has also been argued that where increased efficiency follows privatization, it may be the result of increased competition rather than from a change in ownership. Therefore, where privatization is accompanied by improvement in performance, this may be wrongly ascribed only to a change in ownership or to competition as well, but the true cause may be a change in management, corporate structure or market environment, all of which could be equally important.

3. Privatization and Equity Considerations

In Malaysia, privatization measures are envisaged in the context of the social and economic objectives of the NEP. There is a danger that advocates too pre-occupied with the efficiency objective can undermine specific equity considerations. Thus, equity considerations can be critical in the case of public enterprises which have enjoyed monopoly positions with respect to goods and services produced, and which may continue to enjoy the same monopolistic position in areas such as telecommunications, power generation and distribution, water supply, postal services and transportation after privatization.

1.5. Objectives of Study

In line with these problem areas highlighted above I will attempt to analyse the following:

1. In the chapter on "Share Pricing" I will try to identify whether there have been deliberate attempts by the government to underprice its initial public offerings (IPOs), and whether the objective of wider share ownership has been achieved.

2. In the following chapter on `Ownership and Performance´, I will use evidence to show that improvement in performance has not been a result of privatization per se, i.e. involving a transfer of activities from public to private hands, i.e. a change in ownership, but rather due to a host of exogenous factors that have improved performance.

3. In the final analytical chapter on `Consumer Welfare', I will try to show that privatization has not only brought about the benefits acclaimed by advocates, but has also adversely affected consumer welfare through higher prices charged and poorer services offered.

1.6. Research Methodology

Firstly, in determining whether there has been deliberate underpricing of the initial public offer of government assets, the research will compare the first day premia of private and privatized entities using secondary data collected from the daily price records of the Kuala Lumpur Stock Exchange (KLSE); a study of the net tangible asset backing (NTAB) and, price-earning ratios (P/E ratio) will be undertaken. Such data has been obtained from the prospectuses of companies, the Investors' Digest magazine and the Annual Companies Handbook.

Secondly, in assessing the effects of ownership on performance, the case of Kelang Container Terminal Berhad (KCT) will be discussed. All material relevant to KCT have been obtained from the annual reports of the KCT. (KCT was chosen as the case study as data and information were not readily available for other privatized entities).

Finally, in order to investigate whether consumers have been adversely affected as a result of privatization, studies relating to prices of goods and services of discussed.

Limitations in the collection of data have constituted a constraint as the privatization policy introduced in Malaysia is still recent. Since it may take time for privatization to achieve certain desired objectives, sufficient data and information may not have been obtained.