STATE OWNED ENTERPRISES AND PRIVATE FIRMS IN A COMPETITIVE ENVIRONMENT: A CASE OF PAKISTAN

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ABSTRACT

This study is about the impact of privatization on the state owned corporations in Pakistan. The data set includes a four years before and after measures for operating efficiency. Profitability, output, capital investment and leverage are used as measures for efficiency. The Wilcoxon Z test is used for the comparison of variables before and after the privatization process in Pakistan. The data is selected from various major sectors like cement, oil and gas, banks and financial sector, chemical and auto. The study revealed that no significant financial and operating improvements were exhibited after privatization of these state owned enterprises.

Key Words: Privatization, State owned enterprises, Efficiency

INTRODUCTION

It is a well established fact that the privatization of the state owned enterprises (SOE's) bring in the operating and financial improvement and performance for the divestment of the public sector organizations. This mechanism is used by most of the governments in order to allocate the resources according to the market mechanism. Most of the transition economies of the world i.e. the Eastern and Central European countries and also China along with other developing countries developed much sentiments in order to divest and privatize most of their key publicly held corporations. A lot more reasons add to the inefficiency of the state owned enterprises in the form of ambiguous objectives. The ineffective and inefficient implementation of policies, the large size relative to its financial parameters, the overly crowded and costly most beauractratic structures, inability to respond to customer needs and requirements and also the inability to provide quality and quantity to their various stakeholders.

Another philosophy, backing up the privatization of state owned enterprises, is the roles of state as a regulator of markets but not as the operator of markets. It doesn't mean that the state must not interefer but must exhibit a totally different role. The government must create opportunities to enhance growth and equitable development by creating an envirment for investment, infrastructural and human development. Such a role by the government as a regulator and monitor of markets will enhance healthy competition and will avoid the exploitation of markets by few. Markets in every country must act as vehicles for utilizing and allocation of the scarce resources, followed by decisions of what to produce, how much to produce. Such a trade and distribution can only be done by the entrepreneurs of the private sector but not by the bureaucrats of the public sector. The practice of privatization has been adopted intensively in most of the countries in various forms to achieve their national goals, an account of few has been mentioned below.

Privatization in China

Privatization of the state owned enterprises was a hot issue in the early nineties. The Chinese government like other countries has adopted the same strategy, but kept it under cover and unnoticed from the rest of the world. Privatization in China, although the largest in human history, was carried out in a very unique pattern. Mass privatization was carried out by central governments in the early 1990's, but the Chinese had delayed this strategy because of their dogmatic political thoughts. Ultimately the Chinese city governments initiated the process and also devised the methods and procedures for this purpose. The Chinese privatization was quite and under cover but has proved to be the largest in the world as during 1998 to 2005 the Chinese privatized almost two third of their state assets and SOE's with a total worth of 1.4 trillion US dollars (11 trillion RMB) and a total of ninety thousand firms were privatized Gan et al (2008). The management buy out technique (MBO) was adopted in most of the privatizations carried out in China and this also has turned successful. A few studies has been carried out in this respect to analyze and assess the impacts of privatization on the performance and efficiency of firms in China. Li and Rozelle (2000) studied 88 firms privatized in the Zhejiang and Jiangsu province. The study of Song and Yao (2004) have studied 683 firms in eleven cities during a period of 1995 to 2001. Liu and Lu (2005) studied 451 firms in various sectors during 1994 to 1999. Su and Jefferson (2006) also studied the conversion of state firms into a mix shareholdings. All of these studies concluded that the privatization have improved the efficiency, profitability and performance of firms when converted from a state ownership to that of the privatized one.

The collapse of communism in Eastern Europe has provided an opportunity to the victims of this system to find an alternate. It never took them so long to replace it with the so called the American style capitalism. Consequently a highly state owned and centralized economies were transformed in to an open “market economy” with the private based ownership. A debate was initiated among the East European countries as how to privatize the firms. It was very much difficult to apply the naïve concepts of capitalism as they had the experience with the most inefficient type of state owned firms. The shortage of incapable skilled entrepreneurs, the shortage of firms to assume the role in the capitalist economy , the non availability of local capital for investment, the most risky business environments, the lack of relationship and coordination between entrepreneur, supplier, labor, manufacturer and consumer, ethnic divisions along with the inappropriate work habits further added to propagate the capitalist economic theory into the veins of the broken communist block countries.

Privatization in UK

In 1979, the conservative government led by Margret Thatcher, brought about permanent changes in the role of the state in t he economy. Although there was no

privatization plane, policy and time table with the government to carry out the privatization and also a clear cut rationale for privatization was not provided. The regime always denied the privatization receipts to raise government revenues and to support tax cuts. But in reality the privatization receipts helped to fulfill certain revenue gaps. The major privatization started in early 1980's with the British Aerospace, British Ship Builders, The National Freight Corporation were sold to public as part of large scale privatization involving the worker and management buyout. The Amersham International, Enterprise Oil and the North Sea Oil are among others to be privatized.
Such a large scale and massive transfer of ownership were carried in the forms of trade sales, Initial Public Offerings (IPO's), management and worker's buyouts and the private placements. The privatization of the SOE's in the UK has brought about operating efficiency, profitability improvements, productivity improvement, cost reduction and also exhibited the technological advancements.

Privatization in Pakistan

Since 1970's Pakistan is facing two different policies regarding the role of state in the economy. In the early 1970's, the regime of Zulfiqar Ali Bhutto has made the large scale nationalization of firms with the motive to avoid the concentration of wealth with the few. Also the socialist economic model and the success of Soviet Union provided an intellectual support for this extreme radical action. Two decades later, it was revealed that the nationalization was flawed and unrealistic and the consequences were totally opposite. Nawaz Sharif in 1991 introduced economic reforms and also reduced the role of government in the economy. The privatized enterprises were targeted because of their inefficiency, losses and also the lower returns on investment. Privatization as policy measure was adopted as part of economic reforms and the privatization was set up to open the following sectors for private investment i.e. power, telecom, airline, ports and ship building.

LITERATURE REVIEW

Hakro and Akram (2009) studied the pre and post privatization performance of firms in Pakistan. They have taken 49 units amounting to 72% of the privatization proceeds in Pakistan. Various performance indicators were used to analyse these effects. They confirmed insignificant results and found that the privatization process has never improved the financial performance of firms in Pakistan. Boubarki and Cosset (1998) studied the effects of privatization in twenty one developing countries including Pakistan, Jamica, Bangladesh and Philippine and concluded that the privatized firms show a significant improvements in operating efficiency, profitability, employment and output, increase in dividends and reduction in financial leverage. Rafael and Florencio (1997) in a study of privatized firms in Mexico found an increase in earnings and a decline in the unit cost. The studies of Dewnter and Malatesta (1997) and Thisse (1997) suggest that state owned enterprises are the least efficient as they do not have any exposure to the formal capital markets. There is no mechanism for the monitoring and evaluation of the managerial performance.

Barth et al (2001) in a study argue that the bank performance and the state ownership are negatively related to each other. Also the state ownership can never avoid the financial crisis in the commercial banks. Their study was based on ownership structure and commercial bank regulations from sixty countries. La Porta et al (2002) in a study of state owned banks from ninety two countries concluded that state ownership of banks exist in those countries having underdeveloped financial markets, lower amounts of per capita income, inefficient and interventionist governments. They further argue that the state ownership of banks result into the mild financial development, lower productivity and growth patterns. The study of Clarke et al (2003) suggested that the bank privatization from state ownership results in to the performance improvements.

Martin and Parker (1995) studied the performance of eleven privatized firms after their divestment from the state ownership during a period of 1981 to 1988. Mixed type of results was found during the study as performance improvement was found in less than half of the sample size. But in the meanwhile a few improved as the privatization announcements were declared. Ramamurti (1996) in a study of privatization effects on firm performance in the Latin America during 1987 to 1991 concluded that this privatization proved to be very much effective for the telecom sector because of a better scope for technology and the capital investment. And relatively lower improvements were shown by the airlines. Eckel et al (1997) examined the British Airways privatization with reference to the stock price and decline in route fares after privatization. The study revealed that the stock prices of US competitors decreased after the BA's privatization also the routes fare were decreased drastically after privatization. Newberry and pollit (1997) in a study of cost and benefit analysis during 1990 after privatization and restructuring of the Central Electricity Generating Board revealed that the privatization and restructuring produced cost efficiency and the costs were reduced by five percent. La Porta and Lopez de Silames (1999) assessed the performance of 218 privatized firms during 1992. Convincing results were found as the output and profitability were considerably increased. Wallsten (2000) in an empirical study of the competition, privatization and regulation of firms in Africa and the Latin American countries from 1984 to 1997. The study revealed that privatization can not be fruitful if not coupled with the proper and effective regulations. They further argue that proper regulations must be incorporated and implemented before privatizing a monopoly. Laurin and Bozec (2000) studied the privatization process in Canada. The two largest rail carriers were taken as a case study during an entire period stretching from 1981 to 1998. Various accounting ratios and the stock returns were taken as the sole performance measures. The total factory output/productivity was enhanced to a large quantum after privatization. The stock price of Canadian National increased in the post privatization period. The capital expenditure increased also for both the firms. Megginson et al (1994) compared the three year pre and post privatization performance of 61 firms from eighteen countries including a total of thirty two industries from 1961 to 1989. The study revealed that operating efficiency, output, dividend payment, profitability and capital expenditure were significantly enhanced and the financial leverage was significantly decreased and also changes in the corporate directors were reported.

DATA AND METHODOLOGY

The data set includes a four years before and after measures for operating efficiency, profitability, output, capital investment and leverage. The Wilcoxon Z test is used for the comparison of variables before and after the privatization process in Pakistan. The data is selected from various major sectors like cement, oil and gas, banks and financial sector, chemical and auto. This study used about 44 units out of the 159 units privatized in Pakistan during the previous years. The testable hypothesis and their proxies are given in table 1. The efficiency is measured as percentage change in performance and also the Z-test percentage change in performance in each of the proxy variable for both the before and after privatization periods.

Table 1: Hypotheses

Variables	Proxies	Testable Statements
Operating Efficiency	Net Income Efficiency (NIEF)= Net income /Total employment	$NIEF_A > NIEF_B$
	Sales Efficiency (SALEF) = Sales/Total Employment	$SALEF_A > SALEF_B$
Profitability	Return on Equity (ROE)= Net income/Total Equity	$ROE_A > ROE_B$
	Return on Assets (ROA) = Net income/ Total assets	$ROA_A > ROA_B$
	Return on Sales (ROS) = Net income/Sales	$ROS_A > ROS_B$
Output	Real Sales (SAL) = Nominal sales/ CPI	$SAL_A > SAL_B$
Capital Investment	Capital Expenditure to Total Assets (CETA) = Capital Expenditure/Total Assets Capital Expenditure to Sales (CESA)= Capital Expenditure/Sales	$CETA_A > CETA_B$ $CESA_A > CESA_B$
Leverage	Debt to Assets (TDTA) = Total Debt/Total Assets	$TDTA_A > TDTA_B$

RESULTS AND DISCUSSION

Operating Efficiency:

Net income per employee (NIEF) and inflation adjusted sales are used for efficiency measurements. Both indicators show a significant decrease in value after privatization. The Z statistic value for NIEF is -0.007 and for SALEF is -0.014 which is insignificant for both the variables. This shows that after privatization efficiency could not be achieved.

Profitability:

Profitability is measured on the basis of return on equity (ROE), return on assets (ROA) and return on sales (ROS). Insignificant values for profitability measures were shown even after privatization, which shows that firms are unable to expand profit margin. The results from the Wilcoxon Z test show that ROE, ROA and ROS have significantly decreased after privatization.

Output: The nominal sales to that of CPI are used to measure the output. The Z test show that the real sales are even insignificant after privatization as the median change is negative.

Capital Investment:

Capital expenditure by total assets and capital expenditure by sales are used as a proxy for the measurement of capital investment activity. Since change in both the measures are negative and therefore the Z test is insignificant hence no improvements in capital investment were exhibited.

Leverage: The total debt to total assets value shows a highly insignificant value after privatization. After privatization leverage should have declined but the results are contrary to the expectations.

Table 2: Results

Variables	Median Before	Median After	Change (Median)	Median Differences (Z-Statistics)
Operating Efficiency				
Net Income Efficiency (NIEF)= Net income /Total employment	0.074	-0.030	-0.101	-0.007
Sales Efficiency (SALEF) = Sales/Total Employment	1.187	0.395	-0.796	-0.014
Profitability				
Return on Equity (ROE)= Net income/Total Equity	1.3	-4.65	-5.714	-0.007
Return on Assets (ROA) = Net income/ Total assets	0.033	0.028	0.051	-0.007
Return on Sales (ROS) = Net income/Sales	0.68	-0.064	-0.133	0.052
Output				
Real Sales (SAL) = Nominal sales/ CPI	9.28	3.1	-6.44	-0.412
Capital Investment				
Capital Expenditure to Total Assets (CETA)= Capital Expenditure/Total Assets	0.081	-0.12	-0.179	-0.271
Capital Expenditure to Sales (CESA)= Capital Expenditure/Sales	0.012	-0.022	-0.011	-0.123
Leverage				
Debt to Assets (TDTA) = Total Debt/Total Assets	.271	0.311	0.041	-0.102

CONCLUSION

This study covered a total of 44 units privatized to determine their financial and operating efficiency. The study revealed that no significant financial and operating improvements were exhibited after privatization of these state owned enterprises. The study has found no significant improvement in operating efficiency, profitability, output, capital investment and leverage. The unexpected results might be due to the economic slowdown in the country or the limited data set cannot determine whether the inefficiency is due to privatization or the political instability in the country or due to the combination of some other factors.

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