
Assessing Privatization in Sri Lanka: Distribution and Governance

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In Sri Lanka, privatization is ideologically allied to the liberalization process that jumpstarted the economy in 1977. It was only a decade later, however, that privatization became a state policy, and after 1989 that the sale of public enterprises began to gather momentum. This slow start to privatization is largely attributed to the continued use of state-owned enterprises (SOEs) as vehicles of employment and political patronage (Knight-John 1995).

The 1977–89 period, characterized by macroeconomic instability and political violence, was not conducive to rigorous reform efforts. During the first wave of privatization (1989–94), the government divested 43 commercial enterprises (typified as relatively less complex), raising about rupees (Rs.) 11.6 billion.¹ The second wave of privatization (1995–present), which has witnessed the divestiture and restructuring of several public utilities and major ventures in the services sector, amounts to Rs.46.2 billion.

More recently, the need for structural reforms, including privatization, has been accentuated by the country's dismal economic performance, stemming from a series of adverse external shocks, domestic political uncertainties, and entrenched structural rigidities. In 2001, the economy recorded a negative real growth rate of 1.5 percent—the first economic contraction since

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1. In this chapter, the term *divestiture* refers to both a partial and total sale of state assets to private parties (the one exception is the Public Enterprise Reform Commission [PERC], which classifies six licenses to import and market finished lubricants as divestiture).

independence in 1948—and the public debt to GDP ratio reached 103.2 percent (Central Bank of Sri Lanka 2001a). While a Stand-By Arrangement (SBA) with the International Monetary Fund (IMF), signed in April 2001, eased some of the burden, in terms of external reserve losses, only strong policy commitment and intensive structural reforms can provide long-term economic relief.²

In the current context of economic crisis, privatization's distributional effects require policy prioritization. As the World Bank (2002) emphasized, the burden of macroeconomic crises falls disproportionately on the poor. In an environment of slow or negative growth, high inflation, and high unemployment, such issues as who reaps the benefits of privatization and how the government uses the proceeds from privatization become increasingly pertinent. These distributional questions are especially important given that most of the remaining transactions and those completed during the second wave are in the services and plantations³ sectors, where price, access, and labor issues are particularly significant. Moreover, given the ongoing political conflict, ignoring equity considerations will have severe adverse economic, social, and political effects on the country.⁴

This chapter documents and analyzes Sri Lanka's privatization program of 1989–2002 from a distributional perspective. It aims to identify the program's winners and losers, consider the government's role in devising the form of privatization and mitigating adverse distributional effects, and to better grasp the political economy forces that structure, condition, and ultimately shape the outcome of the privatization process. The chapter is structured according to the conceptual framework outlined in Birdsall and Nellis (2002).

Study Methods and Limitations

Research for this study was conducted mainly through interviews with key stakeholders from eight selected companies and policymakers from such agencies as the Ministry of Finance, PERC, and the Colombo Stock Exchange and (CSE).⁵ Secondary data from the Central Bank, World Bank, and CSE, as well as academic publications by local privatization experts, complemented the interview data. The set of companies selected for the study does not represent a random sample; their choice was governed by

2. Under the SBA, the government agreed to deepening the privatization process.

3. Sri Lanka's plantation sector has a large resident labor population.

4. Even if privatization is not the cause of the poor's economic and social problems, the perception that it causes or exacerbates inequitable income distribution could create political opposition to the privatization process, irrespective of its costs or benefits to society.

5. Appendix 12A briefly describes each target company, and appendix 12B contains the study questionnaire.

data availability and the need to ensure a suitable mix between entities in the manufacturing, services/utilities and plantation sectors in the first and second waves of privatization.

The paucity and incompleteness of existing data present the biggest obstacle to a rigorous analysis of privatization's distributional effects in Sri Lanka. A notable feature, with likely adverse consequences for public policy, is the general unwillingness of players in privatization transactions to divulge information on the process. Thus, lacking sufficient data, much of the study is necessarily based on anecdotal information.

Moreover, vital bits of information—for example, the link between utility privatization and the poor—could not be fully evaluated because of lack of datasets on relevant household-level observations. The latest available household survey is based on 1996–97 data and the two utilities selected for this study: Colombo Gas Company Ltd. (CGCL) and Sri Lanka Telecom (SLT) (privatized in 1995 and 1997, respectively). As such, the study could only use household-level data related to the gas sector.

Socioeconomic Profile

Sri Lanka is a lower-middle-income country, with a per capita GDP of \$872, as of 2002.⁶ Since independence, GDP growth has averaged 4 to 5 percent, with the civil war depressing growth by an estimated 2 percent per year since 1983.⁷ Arunatilake, Jayasuriya, and Kelegama (2001) estimate the economic cost of the war from 1983–96 at about 168 percent of 1996 GDP, equivalent to \$20.6 billion.

In mid-2002, Sri Lanka's population totaled approximately 19 million—with about 80 percent residing in rural areas—and a growth rate of about 1.5 percent. In 2001, labor-force participation was 48.3 percent, and the unemployment rate was 7.8 percent. Approximately 32 to 35 percent of the labor force was employed in the agriculture sector. Given the country's social upheavals, it is particularly disturbing that most of the unemployed are youth: for those 14-to-18 years of age, the unemployment rate is about 36 percent; and for those 19-to-25 years of age, the rate is about 30 percent. Among educated youth, unemployment is approximately 24 percent.

Compared with other countries at a similar level of development, Sri Lanka has a relatively advanced social development status. Life expectancy is 73 years, infant mortality is 15 per 1,000 live births, maternal mortality rate is 23 per 100,000, and adult literacy is 93 percent. Even so, approximately 22 percent of Sri Lankans live below the poverty line.

6. The information in this section draws largely from Central Bank of Sri Lanka (2001a) and the Government of Sri Lanka's Draft Poverty Reduction Strategy from April 2002.

7. During the 1990s, per capita GDP growth averaged about 5 percent per year.

Over the last two decades, income equality has improved relatively, though not substantially. During this period, the Gini coefficient, an indicator of income distribution, declined marginally for income receivers (from 0.52 in 1981–82 to 0.48 in 1996–97). A comparison of the two surveys suggests that absolute poverty decreased marginally between 1990–91 and 1996–97 (from 20 to 19 percent, according to the lower poverty line, and from 33 to 31 percent, according to the higher poverty line). Because of unreliable data, it is not possible to determine how the poverty level changed during the late 1990s. However, the incidence of consumption poverty (head count index) varies significantly across provincial boundaries; the Uva, northwestern, and north central provinces have significantly higher levels of poverty than do the other provinces. According to the higher poverty line, Uva province recorded the highest incidence (55 percent), while the Western province had the lowest (23 percent). A breakdown of incidence of poverty by sector indicates that rural and estate (plantation) sectors have a relatively higher level of vulnerability. The evidence shows that chronic and transitory poverty combined affects about 25 percent of the urban population and 41 to 45 percent of those in the rural and estate sectors, respectively.

The poor also have limited access to basic services—for example, people living in remote areas lack access to markets, information, and basic infrastructure facilities (e.g., good roads, rail, and port systems; well-functioning bus transportation systems; telecommunications networks; and information technology). While basic education and health facilities are widely available, the quality of services available to the poor is vastly inferior to that available to better-off, urban households.

Evolution of Privatization Program

When liberalization began in 1977, the state sector played a significant role in all spheres of the country's economic activities, reflecting the highly interventionist policies adopted from the mid-1950s to the late 1970s.⁸ During this period, the government set up new public enterprises, nationalized several private entities, and created state monopolies. The state secured public support for these policies by emphasizing such populist goals as employment creation, price controls on essential goods and services, distributional equity and regional development in SOE operations.

According to Kelegama (1997a), as a percentage of GDP, the SOE sector grew from about 5.7 percent in 1961 to 12.2 percent in 1974, and to more

8. In 1965–70, a brief, unsuccessful attempt at liberalization was undertaken, in collaboration with international financial institutions.

than 15 percent in 1977. By 1977, the public sector accounted for about one-third of investment and 40 percent of formal-sector employment. Even after 1977, the state sector continued to expand as a result of the large donor-funded infrastructure projects implemented and the political economy factors that restricted the government's ability to carry out intensive public-sector reforms.

Many of these public enterprises became loss-making entities, plagued with problems of overstaffing, mismanagement and corruption, inefficient procurement systems, and excessive government intervention and politicization. Budgetary transfers to SOEs, averaging about 10 percent of GDP in the mid-1980s, were highly unsustainable. Although budget speeches of the then government mentioned privatization, the final push came only after the World Bank highlighted the urgent need to address the massive burden that the state sector imposed on the budget. In 1987, privatization was announced as a state policy, with the primary objectives of alleviating fiscal burden and improving enterprise efficiency through private-sector norms.⁹

Privatization's other stated objectives were encouraging development of an entrepreneurial middle-class, broad-basing share ownership, and activating the capital market. Popular support was sought by dubbing the process "peoplization," meaning handing back the people's assets from the bureaucrats to the people. A presidential decree stated that workers should not lose their jobs as a result of privatization. During the second wave of privatization after 1994, such objectives as "enhancing investment, employment, and quality of service in the privatized sectors"¹⁰ were added to the government's stated expectations from the privatization program. In practice, however, fiscal imperatives—both reducing expenditure on SOEs and raising revenue from the sale of state assets—have influenced and shaped both phases of privatization.¹¹

The modalities for privatization varied somewhat. The most widely used approach was the 51:30:10 formula, whereby a major shareholding of about 51 to 60 percent of an SOE was sold to a corporate investor on the basis of open tenders and competitive bidding; 30 percent of equity was offered on par to the public; and 10 percent was given free of charge to employees based on their length of service. The rationale for the strategy was that corporate investors were given majority share ownership as an incentive to transfer technology and invest productive capital in the enterprises; the

9. Knight-John (1995) documents details of the few random privatization transactions initiated between 1977 and 1989.

10. Quoted from policy statement by Sri Lankan President Chandrika Bandaranaike Kumaratunga, January 1995.

11. Jayasuriya and Knight-John (2002) argue that penetration of rent-seeking activities under weak regulatory conditions, such as those in Sri Lanka, can dilute long-term fiscal benefits through efficiency gains.

public share offering aimed at boosting a shallow capital market and widening share ownership, while the employee share ownership plan (ESOP) was put in place to win the support of trade unions, a group traditionally opposed to privatization.

This standard formula deviated somewhat in the case of particular enterprises: employee buy-outs (Buhari Hotel); gifting of 50 percent of shares to workers in the bus transportation sector; sale of assets of public corporations with the state assuming the liabilities (Ceylon Plywood Corporation); negotiated sale of shares (Thulhiriya Textile Mills to a South Korean company, Kabool); and management contracts (plantation sector).

The five-year management contracts earlier used in the plantation sector were a disincentive to longer-term capital investment in this industry. Thus, in 1995, steps were taken to divest 51 percent of shares of profit-making plantation companies, with the initial offer for purchase made to the management company. Fifty-one percent of loss-making companies were later sold on an all-or-nothing basis on the CSE. More recently in October 2002, a 39 percent stake of six bus companies was to be sold on an all-or-nothing basis on the CSE, with seven other companies in the pipeline for sale. Plans were also underway to forge a management agreement with the successful investor in the transaction. However, difficulties in determining these bus companies' current shareholding structure have delayed this transaction.

During the first wave of privatization, four principles determined which assets were chosen to sell:

- The SOE had the potential to be turned around with an infusion of private-sector capital and technology;
- The stock market had the capacity to absorb the privatized enterprise;
- The enterprise was not involved in an essential economic activity; and
- The enterprise provided little revenue to, or required substantial transfers from, the government.

According to Crowe and de Soysa (1995), the SOEs chosen for divestiture at that time received few public transfers.

By the time the second wave began, the privatization program had graduated to a stage where it could undertake reforms in sectors involved in core economic activities, such as utilities and plantations. According to the PERC and Central Bank reports, 86 SOEs were privatized from December 1989 to September 2002 in the manufacturing, trade, agriculture, plantations, petroleum, financial, utility, and services sectors. However, according to the Central Bank of Sri Lanka (2001a), more than 70 public enterprises still operate in these various sectors of the economy, with cumulative losses in 2000 estimated at about 2 percent of GDP.

Institutional, Legal, and Regulatory Framework

Following the 1987 announcement of privatization as state policy, several measures were undertaken to set up the necessary legal, institutional, and regulatory structures for reform. Two pieces of legislation—Conversion of Government Owned Business Undertakings into Public Corporations Act No. 22 and Conversion of Public Corporations or Government Owned Business Undertakings into Public Companies Act No. 23—were enacted in 1987 to facilitate commercialization of SOEs.

The Public Enterprise Rehabilitation Act, passed in 1996, primarily protected the interests of workers in failed privatized enterprises and limited industrial disputes and social unrest. Under this Act, seven entities were revested with the government, at a cost of nearly Rs.1 billion to the Treasury.¹² However, this Act was operational for only six months, because the private-sector chambers of commerce began voicing concerns about renationalization, and the government did not want to send the wrong signals to the investor community.

Several successive institutions—Presidential Commission on Privatization (later renamed Presidential Committee on Peoplization), Public Investment Management Board, and Commercialization of Public Enterprises Division (COPEP), Ministry of Finance—were developed in 1987–95 to facilitate the privatization process. The new Plantation Restructuring Unit handled privatization of the plantation sector, and a special unit in the Ministry of Industries oversaw privatization of industrial enterprises.

These changes in the institutional framework and diversification of responsibility for the privatization program to various institutions were caused largely by the political climate at the time. With the president facing impeachment proceedings, coalition management was the primary objective of political leadership. Given the need for coalition building, support of the line ministries was vital, and it was not politically feasible to restrict management of the privatization program to one umbrella institution. The involvement of these various line ministries, with their ministers' respective political agendas, led to a systemic politicization of the privatization process.

Politicization of the implementation network raised questions about COPEP's transparency, with allegations of closed-door deals by those opposed to the sale of public assets. To a certain extent, transparency was sacrificed for speed of execution, with policymakers preferring a relatively rapid sale of assets. External donor pressure and the government's desire to prove its commitment drove the need for fast-paced privatization.

In its election campaign, the administration that assumed power in 1994 highlighted the alleged corruption associated with the privatization

12. Three of these enterprises were later reprivatized.

program of its predecessor as a major issue. In 1996, PERC was set up under an Act of Parliament to undertake sole responsibility for the privatization program, with the stated intention of effecting privatization in a structured and transparent environment.

Transparency and access to information with regard to the privatization program improved with establishment of the new institution. Publication of annual reports and other materials, frequent press notices, and the posting of pertinent transaction details on a PERC Web site have, to some extent, increased the public's awareness of the privatization process. However, allegations of questionable deals still prevail.

Several regulatory bodies linked to the program aim to ensure that privatization will bring about both allocative efficiency and distributional equity. However, weak regulatory governance is a major obstacle to realization of positive distributional effects.

Sri Lanka lacks a comprehensive, effective competition policy framework, a prerequisite for an economy moving toward greater private-sector activity. Until early 2003, the Fair Trade Commission, set up in 1987, handled issues related to monopolies, mergers and acquisitions, and anti-competitive behavior. The Department of Internal Trade (DIT), established in 1979, dealt with consumer protection matters. The institutional separation of these complementary functions proved extremely inefficient, and the government eventually integrated the two bodies into the Consumer Affairs Authority (CAA).

However, the process of instituting a competition policy framework faces many challenges, with no assurance that the new authority is equipped to handle the increased private-sector activity. At the time of this writing, the new authority was to be stripped of its powers to consider monopolies and mergers and would function solely as a consumer protection agency. Although reports of a separate Monopolies and Mergers Commission abound in the press, no such body has been created. While it is conceivable and justifiable that the government may want to abolish the perception of a restrictive regulatory regime in order to attract investment and facilitate efficiency-enhancing mergers, the current gap in the competition policy framework is a recipe for disaster.

Currently, sectoral regulation exists more in name than reality, in the cases of bus transport (National Transport Commission) and telecommunications (Telecommunications Regulatory Authority) services.¹³ Links between competition policy/consumer protection authorities and these sectoral regulators, essential for ensuring that competition and distributional goals are met, are rare. The financial sector has relatively more effective

13. For details on Sri Lanka's telecommunications regulation, see Jayasuriya and Knight-John (2002). Establishment of a multisector regulatory framework encompassing the water, power, and energy sectors is in the final stages of implementation.

regulation, handled by the Bank and Non-Bank Supervision Division of the Central Bank, the Securities and Exchange Commission (SEC), and the Insurance Board, set up in 2001 to supervise the insurance industry.

Lessons from Earlier Studies

To date, no studies have looked at the distributional effects of Sri Lanka's privatization using formal empirical methods, such as cost-benefit analyses or construction of elaborate counterfactual models. For lack of data, this study, as well as earlier ones, has been forced to use a second-best approach of the case study.

Kelegama (1995) conducted a seminal study on Sri Lanka's privatization and equity, which traces the distributional consequences of the privatization process from inception until 1993, the period characterized as the first wave. This chapter looks, *inter alia*, at the distributional implications of the divestiture modalities, pricing and valuation of entities for sale, privatization's employment effects, use of sales proceeds, and privatization's social effects (e.g., regional effects and ramifications of removing state subsidies).

The study found that the government underpriced shares of the entities sold on the stock exchange in order to promote share ownership in a larger proportion of the population, minimize new investors' financial risk, and avoid overburdening the domestic capital market. Although the sales were a success—nearly all share issues were oversubscribed—most of these shares were bought by the relatively wealthy. Substantial, persistent underpricing of SOEs came at a high cost to the state, given that the share price of many privatized entities rose considerably immediately after divestiture.

Along with the government's deliberate effort to keep share prices low, SOE sale prices were affected by Valuation Department capacity problems and the rapid pace of the divestiture program (as the structural adjustment recommendations of the World Bank and IMF insisted). Another political economy consideration for the low sale prices was the quest to attract foreign capital, with associated technological know-how.¹⁴

Kelegama (1995) reviewed the ESOP's distributional effect on workers in the entities being privatized. The policy decision to distribute free shares to these employees had three objectives: (1) give workers greater incentive for dedicated work through the sharing of profits, (2) safeguard employee rights by giving them a voice in decision making, and (3) making trade unions more receptive to privatization. The study argues, however, that only the last objective was realized, and to a limited extent because many workers tended to dispose quickly of their shares to meet personal financial commitments.

14. Plantation-sector privatization is a classic case of underpricing, where the market clearing price for a 20 percent stake of the profitmaking entities offered on the stock exchange was also the price set for the 51 percent majority stake.

Kelegama (1995) also notes that privatized entities are located predominantly in urban areas and the more developed provinces and districts. This reality creates the possibility of worker discontent, given the asymmetric and more privileged position of workers in privatized enterprises—with share ownership, wage increases, and long-term dividend payments (some workers did retain their shares)—compared with those in other entities.

Kelegama posits that the goal of public benefit—theoretically the driving force of SOEs—became secondary to that of revenue maximization. Divestiture proceeds, for example, were used primarily to address the fiscal deficit resulting from high levels of debt servicing and defense expenditure; investment of these monies in infrastructure or social welfare projects was, at best, marginal. In addition, removal of state subsidies and resulting price increases associated with the privatization program negatively affected the general public (most clearly seen in the bus transportation case).

A more recent study on privatization's effects on Sri Lanka's employment—specifically, the labor retrenchment experience—is that of Kelegama and Salih (1998). The study focuses on three key issues: voluntary versus involuntary retrenchment, using a compensation package as a safety net, and pre versus postprivatization retrenchment. The findings show that the adverse selection problem tends to undermine voluntary retirement packages; fixed compensation packages prove superior to flexible ones, given rent-seeking trade union behavior and downwardly rigid compensation packages; and preprivatization retrenchment may be suboptimal since it fails to account for more efficient postprivatization restructuring options.

Kelegama (1997b) offers interesting insight into the privatization process's political economy:

The Sri Lankan experience shows that the acts of divestiture defy enunciations of underlying rationale or orderly policy. As in the case of nationalization, privatization consisting of a series of political actions which are guided by diverse, sometimes conflicting factors, implemented by different governments and people, discerning some order out of an essentially disorderly situation could be an academic exercise of little interest to the doers. Even if some enunciation of broad policy could be made, political expediency would compel the practitioners to choose the most feasible path of action, and yet be consistent, given the inevitably broad general character of the policy statement. (92)

Expanding on this argument, one could speculate that, in choosing the most feasible path of action in the face of the political-economy constraints linked to privatization—for example, instituting a rapid divestiture program in an uncertain political milieu when investor interest is minimal—maintaining transparency may not be a priority for implementers, giving rise to allegations of questionable transactions, such as those highlighted in Kelegama (1997b). In the early years, the perception of shady deals was only enhanced by lack of an effective regulatory framework to support the privatization program, reflecting the prevalent thinking at the time that regulatory intervention would restrict flexibility of the privatization exercise.

Table 12.1 Gross and net privatization proceeds as a percent of GDP, selected years

Year	Gross proceeds (Rs. million)	Gross proceeds (percent of GDP)	Net proceeds (percent of GDP)
1990	588.3	0.2	0.10
1992	4,423.5	1.1	0.55
1993	4,918.6	0.9	0.45
1995	3,124.6	0.5	0.25
1996	4,542.0	0.6	0.30
1997	22,396.0	2.5	1.25
1998	4,516.0	0.4	0.20
2001	8,601.0	0.6	0.30

Sources: Central Bank and PERC annual reports and COPED data.

Evaluating Privatization's Distributional Effects

The principal questions this chapter addresses involve privatization's fiscal and investment effects and their link to distributional concerns.

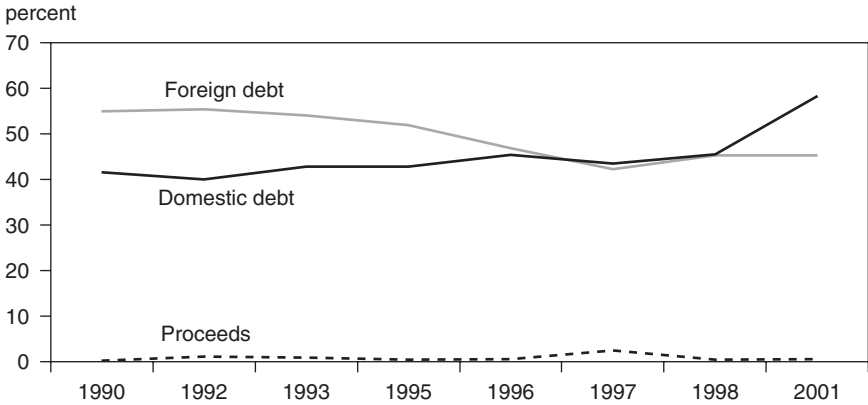
Macroeconomic Effects

During 1989–2002, Sri Lanka's gross proceeds amounted to more than Rs.57 billion. An official figure for net proceeds over this period is unavailable, given that government expenses incurred before privatization for administration, sale, and enterprise restructuring have not been systematically documented. However, we attempt to estimate them, based on IMF estimates, which found, in a sample set of 18 countries, net proceeds averaged about half of gross proceeds (IMF 2000) (table 12.1).

Proceeds from the first wave of privatization were not used methodically for budgetary management or to retire public debt. Kelegama (1997a) estimated that privatization during this period would contribute to an average reduction in the budget deficit of only about 0.6 percent per year. Privatization proceeds went into a fungible consolidated fund, where they were bundled with other sources of fiscal revenue. These monies were used mostly to finance current expenditures. According to the Central Bank of Sri Lanka (2001a), social expenditures throughout the privatization period have remained at about 1 percent of GDP. In terms of distribution, additional privatization proceeds have not been used for social investment projects.

The situation improved after 1995, when privatization proceeds were used more systematically for debt reduction. In the much-cited, Sri Lankan Telecommunications (SLT) case, the government used a substantial portion of the proceeds to retire part of its public debt, thereby lowering the stock of debt, as a percentage of GDP, from 93 percent (1996) to 86 percent (1997). The hope was to reduce interest costs, which posed a major impediment to private-sector activity.

Figure 12.1 Divestiture proceeds and debt burden, selected years
(as percent of GDP)



Source: Central Bank annual reports.

Central Bank annual reports show that, as a percentage of GDP, public debt decreased from 1995 to 1997, reflecting, at least in part, the use of privatization proceeds to retire debt. The subsequent increase from 1998 to 2000 reflects the decline in privatization proceeds during those years.¹⁵ The exceptionally high level of public debt in 2001 stemmed mainly from the increased rupee value of foreign debt, brought about by depreciation of the exchange rate during the year, an oil price hike, and increased military hardware purchases in 2000. The emerging story is that the fiscal crisis (and any negative distributional fallout from it) would probably have been worse without privatization.

The divestiture program was undertaken within the context of a civil war, which has taken a tremendous toll on state resources, and in a macroeconomic milieu where public debt exceeded 100 percent of GDP. Total proceeds from privatization, for example, would cover only one year's defense expenditure, on average. The July 2001 terrorist attack on Sri Lanka's international airport illustrates how small a proportion divestiture proceeds are within the country's political context. In that attack, the government incurred losses of about Rs.28.8 billion (nearly six times the Rs.5 billion the country earned from privatizing the national airline industry). Figure 12.1, which maps privatization proceeds against Sri Lanka's foreign and domestic debt, further illustrates this point.

Table 12.2 and figure 12.2 show that the sales receipts from privatization have, for most of the companies studied, totaled more than the net change in revenue flows to the government before and after privatization.

15. As a percentage of GDP, privatization proceeds were negligible in 1999 and 2000.

Table 12.2 Sales receipts and average revenue flows to the government before and after privatization (net present value)^a

Company	Before privatization (Rs. million)	Number of years	After privatization (Rs. million)	Number of years	Change (Rs. million)	Sales price (Rs. million)
Sri Lanka Telecom (SLT)	2,806.4	4	1,116.8	4	-1,689.60	8,920.0
Sri Lankan Airlines (SLAL)	305.9	4	-206.5	4	-512.40	3,031.6
National Development Bank (NDB)	341.9	3	172.1	8	-169.10	2,705.1
Caltex Lanka Ltd. (CLL)	106.9	3	113.8	7	6.68	968.3
Lanka Ceramics Ltd. (LCL)	56.6	4	12.1	6	-44.50	203.6
Lanka Salt Ltd. (LSL)	11.7	6	1.7	5	-10.00	238.4

a. The discount rate used, 11.1 percent, is the average value of the Commercial Bank weighted average deposit rate for the last 10 years.

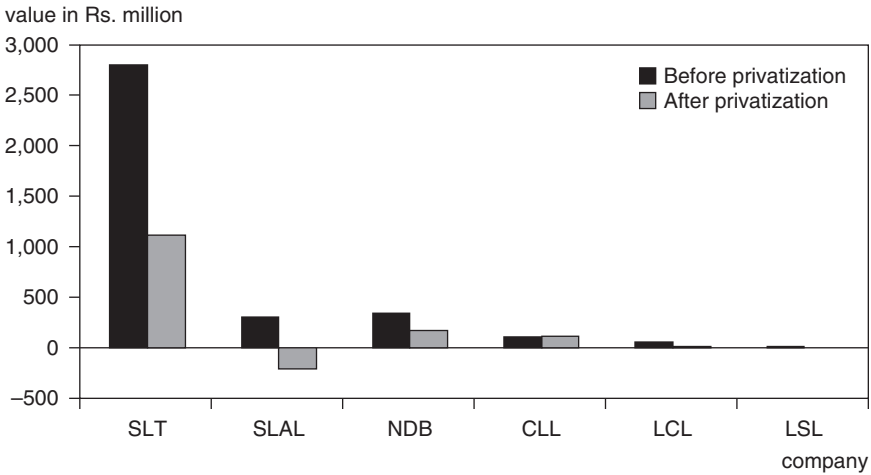
Sources: Company annual reports (various years) and Ministry of Finance (1990).

The privatization program has attracted increased domestic and foreign investment (both direct and portfolio) to key sectors of the economy. Total cumulative investment of seven of the eight companies selected for this study, as a percentage of the country's total private-sector investment, varied from 1.7 to 3.7 over the 1992–2000 period.¹⁶ Its maximum value was recorded in 1997 at 4.5, while its minimum value was in 1992 at 1.7. Emerging stories from individual companies indicate that investment in these entities increased after privatization. For example, since 1999, capital investments of nearly Rs.11 billion went into the plantation sector, averaging about Rs.550 million per company. Over the past five years, SLT has invested more than Rs.40 billion in developing a state-of-the-art communications infrastructure; during 1996–2001, capital investment in the Colombo Gas Company, Ltd. (CGCL) (Shell) averaged about Rs.7 billion (including investment on a storage terminal).

A World Bank commissioned study on infrastructure privatization in 2000–01 indicated that capital investments, measured in terms of capital expenditure to sales and capital expenditure to assets, have fallen with privatization—indicative, perhaps, of a rationalization of capital expenditure (table 12.3).

16. Investment information for Colombo Gas Company Ltd. was not available at the time of writing.

Figure 12.2 Change in privatization revenue flows to government (net present value)



Source: Company annual reports (various years) and Ministry of Finance (1994).

The companies in this sample show mixed results in dividends per share and in profitability profiles after privatization, as illustrated in tables 12.4 and 12.5. Although detailed annual information on the CGCL was unavailable, the World Bank (2001a) indicates that profitability, measured as a return on investment and a return on sales, showed a mean increase of 0.021 after privatization.

No evidence confirms whether the increased investments, where they have occurred, have had positive distributional spillovers. While one could argue that increased investment, particularly in the utilities and services sectors, could be beneficial from an equity perspective (if it led to increased network coverage and service availability), the extent to which this happens depends on key factors, ranging from ownership structures to efficacy of regulatory institutions. For example, Jayasuriya and Knight-John (2002) show that SLT privatization could have had better results (in terms of overall industry competition, prices, and access) if it had not had a monopoly on international telephony and had the regulatory regime been more effective.

One positive result of the privatization program, from a distributional perspective, is the boosting of the CSE, reflected to a certain extent in the market capitalization figures in table 12.6. As Kelegama (1995) argues, foreign investment has tended to drive the share market, with foreign buyers taking up large quantities at relatively high prices, creating an opportunity for smaller investors to make quick money from the bourse. In recent years,

Table 12.3 Capital investment in selected privatized companies

Company	Preprivatization (mean)	Postprivatization (mean)	Change (mean)
Sri Lanka Telecom Ltd.			
Capital expenditure to sales	0.670	0.980	0.310
Capital expenditure to assets	1.420	1.050	-0.370
Colombo Gas Company Ltd.			
Capital expenditure to sales	0.386	0.051	-0.335
Capital expenditure to assets	0.180	0.060	-0.120
Sri Lankan Airlines			
Capital expenditure to sales	0.386	0.089	-0.297
Capital expenditure to assets	0.179	0.059	-0.120

Source: World Bank (2001a).

Table 12.4 Dividend per share, selected companies, 1991–2000 (rupees)

Year	National Development Bank (NDB)	Caltex Lanka, Ltd. (CLL)	Bogawantalawa Plantations, Ltd. (BPL)	Sri Lanka Telecom (SLT)
1991	0.6	n.a.	n.a.	n.a.
1992	3.0	n.a.	n.a.	n.a.
1993	3.5	n.a.	n.a.	n.a.
1994	4.0	n.a.	n.a.	n.a.
1995	4.5	6.00	n.a.	n.a.
1996	5.5	4.00	0.75	n.a.
1997	6.5	4.15	1.00	2.32
1998	6.5	7.60	0.00	1.22
1999	4.5	7.60	0.50	0.70
2000	4.5	7.60	1.50	0.12

n.a. = not available

Source: Company annual reports.

however, civil war and other domestic, political, and economic uncertainties have dampened this positive effect on the stock market.

Ownership Concerns

The distributional effects of sales methods involve such issues as who obtained shares and why, whether share prices reflected the entities' actual value, what measures the government took to ensure that a wide spectrum of stakeholders benefited from privatization, and whether the sales process was transparent.

Table 12.5 After-tax profit for selected companies, 1991–2000
(Rs. million)

Year	BPL	CLL	LCL	LSL	NDB	SLAL	SLT
1991	n.a.	n.a.	n.a.	n.a.	n.a.	201.06	n.a.
1992	n.a.	n.a.	n.a.	n.a.	289.4	218.36	3,205
1993	-67.51	49.46	211.71	n.a.	544.2	127.61	2,531
1994	1.06	73.01	264.48	n.a.	678.3	188.6	3,861
1995	59.67	142.51	268.22	n.a.	616.0	650.05	1,176
1996	113.69	134.83	160.54	18.44	619.2	118.53	1,242
1997	258.21	265.19	210.13	0.45	727.3	449.51	2,390
1998	-2.28	544.40	218.68	5.37	818.9	2,361.36	2,201
1999	108.93	654.53	73.85	8.07	744.7	2,518.63	1,269
2000	168.83	559.00	175.82	8.89	555.8	-750.41	221

n.a. = not available

Sources: Company annual reports.

With regard to the eight companies selected for this study, the government retained a portion of shares in five of them, with a majority shareholding in SLT and Sri Lankan Airlines (SLAL) (table 12.7). Its stated reason for share retention was to protect national interests in what were considered strategic economic sectors. An equally important reason might have been its hope that these shares could later be sold at a premium after the new private owner had driven up the firms' value. In any event, the government postponed, until November 2002, divestiture of an additional tranche of 12 percent of shares (bringing its SLT stake below 51 percent) because of dismal international and domestic financial market conditions and decline in telecom share prices in the international market.

Like many other countries, Sri Lanka has not realized the expected increase in financial gain from secondary sales, as illustrated in two recent transactions: National Insurance Corporation (NIC) privatization and SLT initial public offering (IPO). In the case of NIC, a 51 percent stake was divested in 2001; further privatization was left for a later date, in the hope that the new owner would increase investment in the entity and drive up the share value. However, during the second stage of privatization, the original private investor, who had increased bargaining power because of few takers for the shares, bought a 39 percent stake for a lower per-share price than that originally paid. Similarly, the 2002 SLT IPO saw a 12 percent stake sold for Rs.3,250 million, while a 35 percent stake fetched Rs.13,380 million in 1997. From both a revenue generation and equity perspective, one might argue that the sale of all shares in the first round would more likely maximize proceeds (and thus increase available resources for assisting distribution). Another reason for retaining shares for later sale in the form of an IPO was to reserve equity for sale to local investors. Thus, the approach had a distributional objective.

Table 12.6 Market capitalization, selected years

Year	Total (Rs. billion)	Total privatized companies (Rs. billion)	Total privatized companies as percent of total	Selected companies	Selected companies as percent of total
1990	36.8	1.1	3.0	n.a.	n.a.
1992	66.2	2.8	4.2	0.7	1.1
1994	143.2	4.4	3.1	0.5	0.3
1996	104.2	7.3	6.9	1.0	0.9
1997	129.4	8.6	6.6	1.1	0.8
1998	116.7	9.4	8.1	1.3	1.1
1999	112.8	9.6	8.5	1.3	1.2
2000	98.2	28.0 ^a	28.5	19.5 ^a	19.8

n.a. = not available

a. The SLT debenture issue in March 2000 accounts for relatively high market capitalization.

Sources: Central Bank of Sri Lanka (2001a) and CSE data.

Nonetheless, we believe the government generally gave fiscal concerns precedence over distributional ones. For example, in the SLT privatization, Nippon Telegraph and Telephone Corporation (NTT) received a five-year monopoly to provide international telephony. In the case of CGCL privatization, the contract specified that Shell Overseas International BV/Royal Dutch (Shell) would be the only company to undertake liquefied petroleum gas (LPG) business for a five-year exclusive period. The justifications for exclusivity periods range from attempting to attract Fortune-500 companies as owners, to needing the new owners to make a firm investment commitment (particularly important for infrastructure firms, where underinvestment had produced problems of service quantity and quality), to having to make a political choice between increased prices (particularly in the case of utilities) and time-bound exclusivity.

The reasons for awarding exclusivity periods to investors in the utility sector may be economically valid—it was indeed necessary to find a solution for lack of investment capital in these sectors. However, lack of strong, effective regulatory mechanisms resulted in the abuse of this mechanism. Jayasuriya and Knight-John (2002) argue SLT is not only granted the monopoly in international telephony; it also dominates competitive portions of the market, which has had an unfavorable spillover effect on consumers and competitors. Weak, unenforced regulation is illustrated by SLT's refusal to acknowledge the Telecom Regulatory Commission's (TRC) decision on interconnection and its repeated blocking of competitors' calls.

Deciding to hand over management control to a strategic, often foreign, investor was based on the reasonable premise that a single core investor would show greater commitment to increasing profitability and efficiency and would also be more likely to introduce new technology and better management practices in the privatized entities. However, frequent allegations of nontransparent tender procedures undermined public confidence in privatization, as it was generally believed that those given the opportunity to

Table 12.7 Method of sale for selected companies

Company	Privatization modality (percent)	Stock-market listing status
BPL	<ul style="list-style-type: none"> ▪ 51 (strategic investor with management control) ▪ 39 (public share issue) ▪ 10 (ESOP) 	Listed
CGCL	<ul style="list-style-type: none"> ▪ 39 (retained by government) ▪ 51 (on tender to strategic investor) ▪ 10 (ESOP) ▪ Management control to strategic investor for 5 years 	Not listed
CLL	<ul style="list-style-type: none"> ▪ 51 (on tender to strategic investor) ▪ 39 (public share issue) ▪ 10 (ESOP) 	Listed
LCL	<ul style="list-style-type: none"> ▪ 32.67 (retained by government) ▪ 15 (sale of majority shareholding on an all-or-nothing basis) ▪ 42.33 (public share issue) ▪ 10 (ESOP) 	Listed
LSL	<ul style="list-style-type: none"> ▪ 90 (on tender to Employees Trust Fund Board) ▪ 10 (ESOP) 	Not listed
NDB	<ul style="list-style-type: none"> ▪ 26.3 (retained by government) ▪ 20.9 (sale of majority shareholding on an all-or-nothing basis) ▪ 34.4 (public share issue) ▪ 8.4 (international placement and on CSE) ▪ 10 (ESOP) 	Listed
SLAL	<ul style="list-style-type: none"> ▪ 51 (retained by government) ▪ 40 (on tender to strategic investor) ▪ 9 (ESOP) ▪ Management control to strategic investor for 10 years 	Not listed
SLT	<ul style="list-style-type: none"> ▪ 61.5 (retained by government) ▪ 35 (on tender to strategic investor) ▪ 3.5 (ESOP) ▪ Management control to strategic investor for 5 years 	Only debenture issue listed

CSE = Colombo Stock Exchange

ESOP = employee share ownership plan

Note: This initial composition of shareholdings could have changed over time with the subsequent resale of shares, such as the case of SLT, where some employees chose to sell their shares to NTT, thereby lowering employees' share to 3.3 percent and raising NTT's to 35.2 percent.

Sources: COPED, CSE, and PERC data.

purchase enterprises were the politically well-connected. Thus, belief was widespread that more competitive bidders might have been locked out, with potentially beneficial distributional opportunities lost in the process.

Two examples of questionable deals, repeatedly cited in the media and public fora, are the Kotagala Plantation divestiture and the Prima flour-milling operation. These transactions spanned the regimes of successive

governments from 1977 onward (Kelegama 1995). The Kotagala transaction controversy related to the winning party's connection to the law firm retained by PERC to act on its behalf, raising the suspicion that the selected buyer might have been privy to information unavailable to other investors.

Prima stands out as an imposed monopoly, whereby successive governments enhanced the concessions handed out by their predecessors, calling into question the government's capacity to treat important private firms with neutrality. According to Prima's 1977 agreement with the government, the company was to set up a flour-milling operation and was given a 20-year lease, starting the date the mill became operational. This was the country's first build-own-transfer (BOT) project. In 1986, the agreement period was extended five years; due to an import ban on wheat until 2005, a monopoly ensued, requiring the government to obtain Prima's concurrence to import flour, even in emergency situations.

The company also had the benefit of a tax holiday during this entire period. According to PERC's 2000 annual report, even the personal effects of Prima's expatriate employees were exempt from income tax for a five-year period. The controversy surrounding Prima's monopoly rights grew more complex when the company was discovered to have been engaged in anticompetitive business practices in the chicken feed market. Although the administration that came into power in 1994 had spoken disparagingly of Prima's monopoly rights of operation, this period witnessed the conversion of the BOT project into a build-own-operate (BOO) project and the below-market sale of mill assets.

Lack of openness in the sales process has created antiprivatization ripples among the general public, particularly when strategic investors have been foreign nationals. Table 12.8 illustrates a more positive view of wider share ownership. Accordingly, the percentage of nonresident enterprise ownership is not significant, indicating that remittances abroad are unlikely to be high, as opposed to such foreign strategic investors as NTT, Emirates Airlines, and Shell.

Figures 12.3 and 12.4 show how value added has been distributed among the stakeholders in the National Development Bank (NDB) and Bogawantalawa Plantations, Ltd. (BPL).¹⁷ In the case of NDB, employee remuneration and shareholder dividends have improved in relative terms; for BPL, employee remuneration has declined over the selected time period.

Although an accurate picture of shareholder income and regional breakdown is not attainable, given that private companies do not make this information public, standard investment behavior among the Sri Lankan public suggests that relatively poor, semi-urban, and rural investors have not been

17. Value added is calculated as total turnover minus bought materials and service fees (including management fees).

Table 12.8 Total shareholders, showing resident and nonresident ownership, for selected listed companies, 1995 and 2000

Year	Total number of shareholders	Resident ownership (percent)	Nonresident ownership (percent)
1995	1,409	98.2	1.7
2000	33,990	97.3	2.6

Note: Selected listed companies are BPL, CLL, LCL, and NDB.

Sources: Company annual reports.

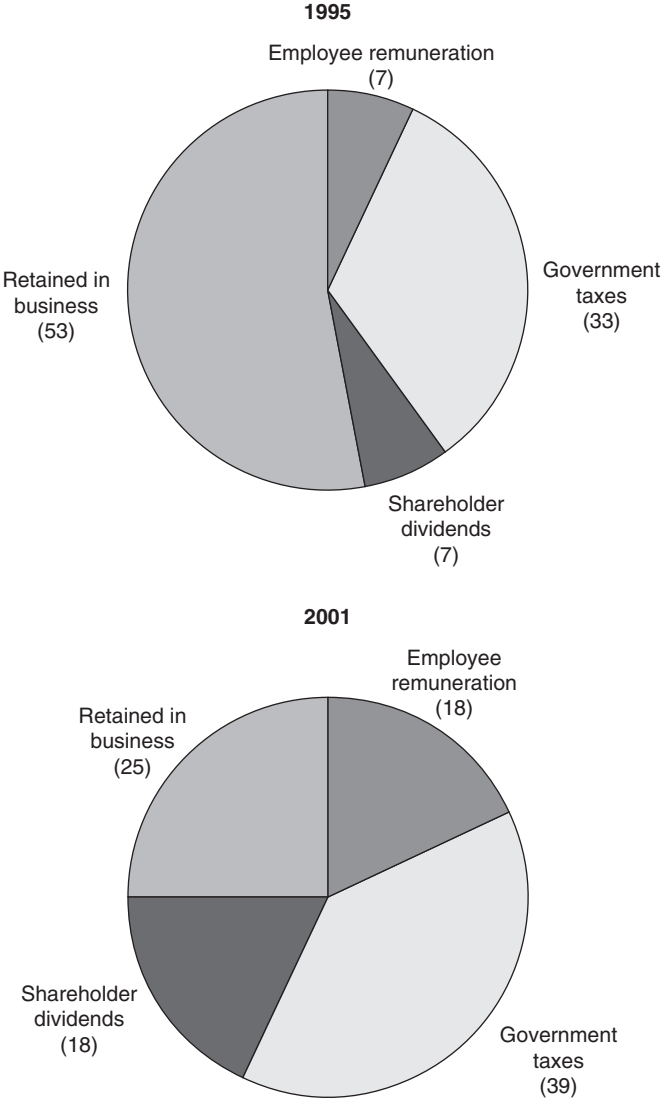
drawn into the stock market. Clearly, low-income groups have little disposable income to invest, and traditional forms of Sri Lankan investment continue (e.g., house and property, and gold and jewelry) (Kelegama 1995).

While unit trusts, which aimed to bring small investors into the stock market, were introduced as early as the 1990s—with initiation of the privatization program—they have not been popular, perhaps because of poor marketing, especially in suburban and rural localities and among lower-income groups. Thus, it is not surprising that those who have benefited from the sale of shares under the privatization program are overwhelmingly urban residents and wealthier segments of Sri Lankan society.

A particularly controversial issue is the alleged underpricing of enterprises sold. Among the privatization program's stated objectives was pricing shares affordably for a large segment of the population and minimizing the financial risks of first-time (presumably small) investors. Kelegama (1995) views the subsequent rise in privatized entities' share prices as evidence of shares having been sold below their true value at the time of divestiture. Underpricing is a plausible explanation for the dramatic rise in share price on the day of privatization; however, in many cases, increased share price came several months after privatization, making it difficult to determine whether the cause was underpricing or improved performance under new ownership and management. To the extent that underpricing was the cause, government and taxpayers lost out at the expense of new owners; moreover, the larger the loss, the greater the negative distributional effect. The second wave of privatization, by contrast, has witnessed the adoption of a more professional procedure, whereby a business valuation is implemented parallel to the government valuation.

Whatever the position with regard to divestiture pricing, persistent and widespread allegations of state asset undervaluation have had a harmful effect on the public's perception of privatization. One example was the media's outcry over what was perceived as gross undervaluation of national assets in the SLAL privatization. Press critics, in particular, objected to the

Figure 12.3 NBD distribution of value added, 1995 and 2001 (percent)

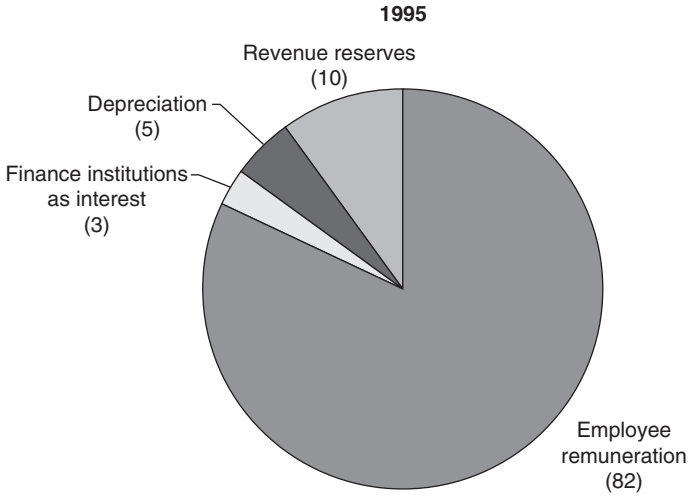


Source: Company annual reports.

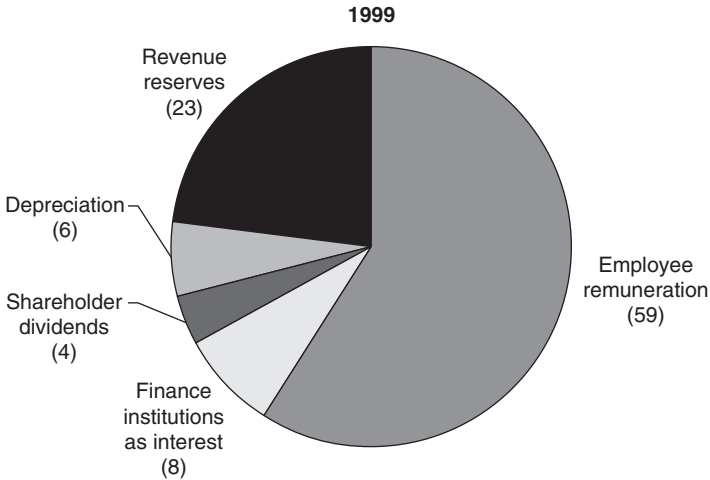
government’s allowing the purchaser, Emirates Airlines, to pay US\$45 million (of the total US\$70 million sales price) upfront, with the balance to be paid over the ensuing 30 months.

The government’s efforts to democratize share ownership through ESOPs have had mixed results. The most positive outcome is that trade unions

Figure 12.4 BPL distribution of value added, 1995 and 1999 (percent)



Note: Government taxes and shareholders dividend equal zero percent.



Note: Government taxes equal zero percent.

Source: Company annual reports.

are appeased and somewhat more receptive to privatization. However, employees at higher management levels, with more knowledge about how to make and use share-market investments, have benefited most. Attempts to create a share-owning culture among employees of the privatized enterprises have been diluted by employees' tendency to sell their shares in the short term. For example, according to company annual reports, shares

held by SLT and SLAL employees stood at 3.3 percent and 5.37 percent, respectively, in 2001, in contrast to initial holdings given out at the time of privatization of 3.5 percent and 9 percent, respectively.

Whether those employees who held onto shares gained or lost over time has depended on the country's overall stock market conditions and individual company performance. As table 12.9 indicates, the per-share earnings given out at the time of privatization of the companies in the sample set chosen for this study have increased over time, on average, with the exception of Lanka Ceramics, Ltd. (LCL), implying that NDB, Caltex Lanka, Ltd. (CLL), and BPL employees would have benefited from holding onto shares.¹⁸

Labor Force Costs and Benefits

In every country, privatization's effect on employment is highly contentious. It inevitably leads to confrontations with trade unions, a visible, vocal, and well-organized group with strong political bargaining power (as opposed to consumers who are dispersed, often silent, and unorganized). In Sri Lanka, for example, organized labor's leverage on governments contributed significantly to the overstaffing of SOEs and postponement of public-enterprise reforms.

In analyzing privatization's costs and benefits to the labor force, the principal questions are: What are privatization's direct effects on job losses or gains? How have remaining employees in the privatized entities benefited from ownership and management change? What are the distributional effects of severance packages given to retrenched workers? We also consider privatization's indirect employment effects stemming from location of privatized entities and privatization's effects on input suppliers. In Sri Lanka's current macroeconomic climate—characterized by high unemployment and a looming social crisis, with youth comprising 71 percent of the country's unemployed—employment concerns are significant.¹⁹

During the period before and just after privatization, the net job loss was 5,419 employees (table 12.10). According to company annual reports, gross job reduction was 6,432 employees, with only 2,533 or 39 percent compensated for their loss. Of the selected companies, BPL, CGCL, CLL, LCL, and Lanka Salt, Ltd. (LSL) reported overemployment before privatization. After privatization, CGCL reported average labor redundancy of 55 percent, while BPL reported 17 percent, and LCL 45 percent. Although SLAL did not report overemployment problems at the time of privatization, the loss of 50 percent of its aircraft fleet due to the July 2001 terrorist attack on Sri

18. It should be noted that, in this case, the equity effect of retaining or selling shares is closely associated with a worker's individual utility trade-off.

19. Draft Poverty Reduction Strategy, April 2002.

Table 12.9 Earnings per share for selected listed companies, 1991–2000

Year	BPL	CLL	LCL	NDB	SLT
1991	n.a.	n.a.	n.a.	4.7	n.a.
1992	n.a.	n.a.	n.a.	5.4	n.a.
1993	(135.04)	1.65	n.a.	10.1	n.a.
1994	2.13	2.43	0.97	12.6	n.a.
1995	6.88	4.75	0.17	11.5	n.a.
1996	5.68	4.49	0.27	11.5	n.a.
1997	11.21	8.84	2.24	13.5	1.32
1998	(0.07)	18.15	1.81	14.9	1.22
1999	3.25	21.82	(1.97)	13.3	0.72
2000	5.04	18.63	(2.31)	10.2	0.12

n.a. = not available

Sources: Company annual reports.

Lanka's international airport led to a downsizing of 1,016 employees in 2001 under two voluntary severance schemes.

Sri Lanka, like many countries, has practiced retrenchment before and after privatization. Guided by the 1987 Presidential Commission Report on Privatization, the government carried out retrenchment before privatization in several entities during the first wave. One of the earliest compensation packages, Bulumulla Formula (Kelegama and Salih 1998), was devised in negotiations with workers' representatives before the enterprise was sold. The rationale for downsizing before privatization was to placate labor, make the entities more attractive to private investors, and obtain a higher price for the entity. However, private owners also had the option of retrenching excess labor by implementing compensation schemes approved by the commissioner of labor. In recent years, the government has tended toward postprivatization retrenchment mainly because it can no longer afford the large compensation demanded by trade unions.²⁰

Before May 1992, both voluntary and involuntary retrenchment schemes were used when the then-president pronounced that no worker should lose employment as a direct result of privatization. Following this announcement, voluntary retirement became state policy. According to Kelegama and Salih (1998), before privatization, the government gave workers at least three months to decide whether they would take voluntary retirement, compared to only two or three weeks after privatization.

20. According to Kelegama and Salih (1998), during 1987–97, average compensation, excluding gratuity payments, increased from 17.5 months of salary to 53 months of salary for a 40-year-old worker with 20 years of service.

Table 12.10 Direct employment effects of privatization for selected companies (average employment)

Company	Year of privatization	Before privatization	After privatization	Change
SLT	1997	7,599	8,499	900
SLAL	1998	4,358	4,908	550
CGCL	1995	646	292	-354
NDB	1993	188	311	123
CLL	1994	320	275	-45
BPL	1992	20,031	16,501	-3,530
LCL	1992	4,082	2,021	-2,061
LSL	1997	1,562	560	-1,002
Total		38,786	33,367	-5,419

Sources: Company annual reports.

Anecdotal evidence suggests that involuntary dismissals after privatization were common. However, a mitigating factor was the Termination of Employment Act of 1971 (TEA), which applied only to the private sector, under which an employer with 15 or more workers wishing to dismiss an employee (with one or more years of service) on nondisciplinary grounds must obtain the employee's written consent or labor commissioner's approval.

Overall, employees retained in privatized entities benefited from improved pay and better working conditions because second-wave privatization agreements required investors to guarantee employment under the same terms and conditions as before privatization and because of increased productivity in several entities.²¹ The companies selected for this study reported increased labor productivity after privatization (table 12.11).²² Table 12.12 shows the average nominal wage investment increment after privatization for the eight surveyed companies.

Privatization's overall distributional effect on workers retrenched under severance schemes can be estimated only roughly, given that precise

21. When comparing the terms and conditions of SOE workers with private-company workers, one should consider that SOE workers are given pensions after retirement that can be accessed on a monthly basis, while private company workers have provident fund schemes, whereby the total amount can be withdrawn at one time. From a life-cycle perspective (and that of smoothing out consumption over time), the option of a one-time withdrawal may not necessarily benefit the worker.

22. Although comparative SLAL numbers were unavailable, interviews with company personnel revealed that salaries of nonexecutive staff increased 44 percent in 1999 and that salaries and other pecuniary allowances of pilots, engineers, and management staff increased substantially after privatization.

Table 12.11 Labor productivity for selected companies

Company	Before privatization	After privatization	Change
BPL (total production per employee) (kg)			
Rubber	3.2	4.9	1.7
Tea	2.1	2.7	0.6
LSL (total production per employee) (metric tons)	96.6	128.6	32.0
SLAL (load carried per employee) (ton-km)	104,855.3	122,331.7	17,476.4
SLT (exchange capacity per employee) (lines)	30.7	80.0	49.3

Sources: Company annual reports and Ministry of Finance.

information is unavailable on such variables as laid-off worker characteristics (e.g., age, sex, and skill level) and the average period of time to find a new job. Moreover, although three severance or compensation packages—Bulumulla, Leather Corporations, and Lanka Ceramics—have been used in the privatization process, several companies have also formulated individual severance schemes, making it difficult to draw conclusions on retrenched workers as a group (Kelegama 1995).

The companies selected for this study have used a range of schemes: individual (CGCL, CLL, and SLAL), Bulumulla Formula (BPL and LSL), and the Lanka Ceramics and Bulumulla Formulas together (LCL). While these schemes vary somewhat, all have adopted a compensation procedure based on number of years of service, whereby employees with longer service are more highly compensated. This approach could negatively affect distribution in situations where those retrenched are younger and have more working years ahead of them, have worked for relatively few years in an enterprise, or belong to employment categories in which job opportunities are scarce. On the other hand, surveys in many countries indicate that workers with these characteristics are likely to find replacement jobs comparatively easily. That the government has not made unemployment safety nets (e.g., retraining and assistance in developing business skills) a policy priority exacerbates the issue.

Kelegama and Salih (1998) argue that, if the majority of those who opt for compensation packages are over the age of 45 and if those who leave are—as in the case of bus transportation system privatization—white-collar workers (Knight 1993), who are more easily reemployable, then the distributional results would have differed. To reiterate, the high financial costs of retrenchment and resulting fiscal effects suggest that at least some retrenched workers would have benefited at the expense of the relatively poor and unemployed.

Table 12.12 Privatization's effects on wages of selected companies
(percent increase after privatization, until 2001)

Company	Average nominal wage increase
BPL	50.0
CGCL	140.0
CLL	120.0
LCL	17.5
LSL	35.0
NDB	150.0
SLAL	52.0
SLT	60.0

Sources: Company annual reports.

Kelegama (1995) posits that, although privatized enterprises were located predominantly in urban areas during the first wave of privatization, the second wave might have had more favorable distributional results, given the location of several privatized entities—plantations, sugar companies, and rural seed-paddy farms—which might well have produced an increase in local and regional employment opportunities.

Privatization has not especially benefited input suppliers whose linkages with SOEs were severed after divestiture. In instances where sourcing arrangements were altered for reasons of efficiency, one might argue that the broader distributional effects of these shifts would be positive, although it might still impose costs on certain local producers. For example, Kelegama (1997b) cites the cases of the Distilleries Corporation, which shifted its purchase of sugar inputs from the local Sevanagala Sugar Corporation to cheaper South African imports, and the privatized Puttalam Cement, which stopped purchasing sacks from Colombo sack makers.

Price and Access Effects

How has privatization affected consumers in terms of affordability, access, and quality? Given that distributional issues are particularly relevant in the utilities sector, what has happened to prices after privatization and why? With regard to telecommunications- and LPG-sector privatizations, have services expanded and, if so, in which localities?

As Jayasuriya and Knight-John (2002) highlight, SLT's international tariffs fell 8 percent in 1998 and 1999. At the same time, a rate rebalancing agreement was reached with the government to substantially increase domestic tariffs during 1998–2002 in five stages: 1998 (25 percent), 1999 (25 percent), 2000 (20 percent), 2001 (15 percent), and 2002 (15 percent). The other fixed telephony operators tend to follow the tariff rates set by SLT, the market leader (with about 85 percent control of the fixed access market).

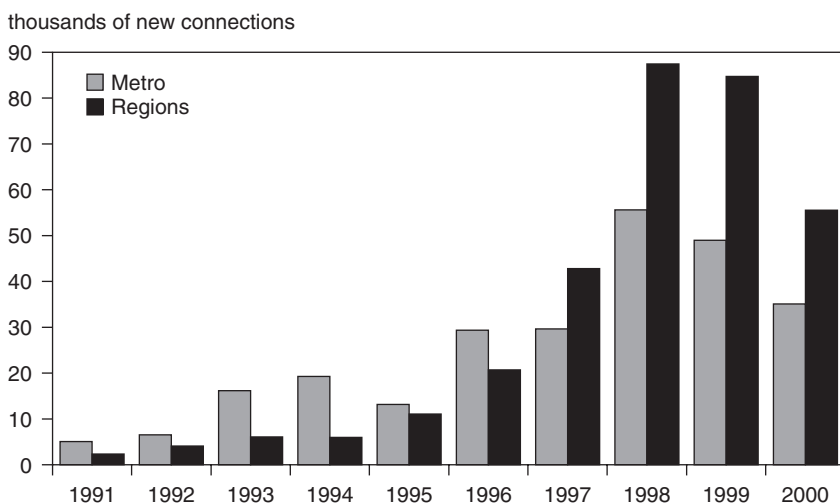
A sound economic argument underlies rate rebalancing. When state-owned, the firm set local call rates at levels below marginal cost. However, because most fixed-access customers subscribe to domestic call services and only a small proportion (the relatively wealthy) has access to international direct-dialing services, the distributional effect of rate rebalancing may not be optimal. In the telecommunications market, price issues were exacerbated by the five-year monopoly on international telephony given to SLT under the privatization agreement, which kept tariff rates in the international segment above competitive rates and stifled other subsector growth, such as Internet services, which could positively affect rural connectivity.

In the oil and gas sector, after privatization, the LPG market recorded price hikes, with the average LPG unit rising about 54 percent (from Rs.18 per kg before privatization to Rs.27.8 per kg after privatization in 1995). Unlike the period before privatization, when the state entity absorbed global price increases, Shell passed these increases on to the consumer. However, given that middle- and high-income groups account for about 92 percent of total Sri Lankan consumption (and that LPG penetration among Sri Lankan households is only about 20 percent, with 80 percent still using kerosene and firewood for cooking), the distributional effect of price increases on the relatively poor is not significant, or is perhaps even positive, depending on how the government directs the funds formerly used to subsidize LPG prices for upper-income consumers.

CGCL company representatives cite high import dependence (of nearly 90 percent of domestic LPG requirements), higher international LPG prices, and devaluation of the rupee as the main reasons for these price hikes. Cost components of the LPG tariff include the product cost (FOB), freight and insurance, terminal throughput fee, company recovery, distributor and dealer margin, and government taxes and duties. The cost of LPG is exogenous—based on the Saudi Aramco contract, which is indexed to spot prices of crude and other oil products.

Although isolating privatization's effects from other exogenous factors proves difficult without accurate data, that LPG prices decreased when another supplier entered the market in 2001–02, consequent to the ending of Shell's five-year exclusive period, suggests that lack of competition contributed to the earlier price increases. Shell representatives argue, perhaps justifiably, that its competitor can sell its product at a lower price since it purchases LPG from the Ceylon Petroleum Corporation (CPC) at subsidized rates. Whatever the case with regard to the pricing issue, opponents of

Figure 12.5 Telecommunications-sector geographic access, 1991–2000



Source: Company annual reports.

the privatization process have been vociferous about Shell's price increases after privatization.

Lack of a sectoral regulator has heightened negative perceptions about gas privatization. Although the privatization agreement signed between the government and Shell stipulates that the DIT would function as the regulator, company representatives claim that their regulatory dealings during the monopoly period have been with PERC, indicating a significant inconsistency in the policy process. Whether an entity set up to facilitate privatization transactions can simultaneously carry out regulatory functions and remain effective in the dual roles is questionable.²³

Price increases after privatization result partially from the shift from a system of hidden subsidies and administered price mechanisms to more market-determined, cost-based price structures. Moreover, the opportunity costs of lower, subsidized prices could be of poor quality, as was the case in Sri Lanka's telecom sector. In this industry, the distributional effect of rising prices has been offset, to some extent, by qualitative improvements after privatization. For example, the average waiting time for a line

23. The five-year monopoly recently given to Shell's competitor to purchase LPG from CPC, apparently without calling for tenders, suggests that lack of an effective regulator could have effects that go beyond the issue of Shell privatization.

has been reduced from seven years to less than one year, call completion rates are now about 46 percent (because of the increase in lines and relocation of equipment to high usage areas), fault clearance rates have improved, and the billing system has been computerized.

SLT and CGCL network expansion after privatization resulted in improved access to these services in absolute terms. Both companies' annual reports show an increase in the average number of consumers; SLT recorded an average increase of 473,000, while CGCL had an increase of 329,000. Further evidence of improved access to these services is SLT's average increase in new connections—from 30,487 before privatization to 109,972 afterward—and a 150 percent increase in the number of LPG cylinders issued between 1994 and 1999. Thus, to a certain degree, expanded service after privatization compensates price increases. Although one cannot state with certainty that privatization is responsible for the increased access, the rate of network expansion grew significantly after privatization.

One can link the average gas expenditure before and after privatization to income levels. The pattern that emerges from these calculations is that the gas expenditure of lower-income groups decreased after privatization. According to the Central Bank's annual reports, for consumers whose monthly income was less than Rs.600 in 1986–87, the average gas expenditure was Rs.0.307; for the same income level in 1996–97, its value was Rs.0. However, the average gas expenditure for middle- (Rs.600–Rs.3,000) and higher-income (more than Rs.3,000) groups increased drastically over the same period. It is evident that the average annual gas expenditure for middle- and higher-income groups increased 61 percent and 11 percent, respectively, during this period.

As figure 12.5 indicates, the growth rate of SLT's new connections in the metro areas decreased, while regional rates increased. However, given that SLT classifies all nonmetro areas, including suburban localities, as regional, these numbers do not accurately portray access in rural areas, where poorer residents are concentrated.

Moreover, Jayasuriya and Knight-John (2002) indicate that, while universal service obligations (USOs) in Sri Lanka relate primarily to rural connectivity, SLT's rural penetration rate is only 1.70, and SLT has no legally binding USOs under the privatization agreement. While data constraints make it impossible to calculate changes in the rural poor's access to telecommunications service after privatization, the low penetration rate (in absolute terms) indicates that privatization would have had only a limited, if any, effect on rural access.

Political Economy Effects

Two interrelated themes that recur in Sri Lanka are public perceptions of privatization and political economy determinants of the divestiture process.²⁴ Privatization's opponents have figured more prominently in public debate than have its proponents; even supporters have had reservations with regard to the process, particularly regarding such issues as the sales price of entities, exclusivity provisions, and labor retrenchment. Strong ideological feelings of national pride, combined with the general public's lack of awareness about the program and absence of procedural transparency, provide an excellent opportunity for politicizing the issues and stirring up antiprivatization sentiments among those with vested interests.

According to the survey contained in the 2001 World Bank–commissioned study (World Bank 2001b), most Sri Lankans had heard of privatization, but were pessimistic about it; more than 50 percent believed that social life and economic stability had deteriorated with privatization and over 80 percent perceived that privatization would negatively affect poverty and living standards. While only about 60 percent and 50 percent of respondents knew about telecommunications and bus privatizations, respectively, as many as 50 percent thought that the electricity sector was already privatized, which was not the case. On the other hand, more than 80 percent of respondents were aware of gas privatization—perhaps because, after divestiture, the media constantly highlighted the controversial issue of Shell gas prices.

Regarding the rationale for privatization in Sri Lanka, the perceived reasons recorded by the survey ranged from donor pressure (SLT), government escape from mismanagement and a loss-making situation (SLAL and Shell), and formulating an exercise in “peoplization” (buses). Survey respondents viewed telecom privatization as having brought about better service and access, and saw it as a fair trade-off for increased prices. They also perceived bus privatization as having improved service and access to a certain extent, but thought that lack of well-defined sectoral procedures and discipline negatively affected service quality and consumer welfare. The privatization of SLAL was thought to have been disadvantageous to the country. In general, price increases and loss of job security were viewed as the most problematic outcomes of privatization.

With regard to future privatization plans, more than 60 percent of respondents opposed the sale of ports and banks; more than 50 percent opposed sale of the insurance sector; and more than 70 percent opposed divestiture of electricity, water, and railway sectors. Clearly, this scenario is unfavorable, given that all of these sectors are included in the government's imminent privatization pipeline.

24. Our analysis of public attitudes toward privatization draws from a 2001 World Bank–commissioned study, whose more salient findings and claims are presented in this chapter. See World Bank (2001b).

Reactions to privatization vary among the various stakeholders involved in the process; perceptions and reactions are shaped by what one stands to gain or lose through the reform. Not surprisingly, the most enthusiastic promoters are the relatively well-off, who have the opportunity to purchase (possibly underpriced) state assets through a process tainted by lack of transparency. The promise of continued rents from handing out exclusivity provisions under many privatization agreements in the second wave has further strengthened this favored group's support.

Unsurprisingly, labor has not supported the privatization process, given the SOEs' guarantee of job security and the perception, cultivated over years of heavy government intervention in the economy, of a benefactor state. The presence of vociferous trade unions with strong bargaining power and the ability to create industrial unrest has prompted the government to introduce such measures as the ESOPs and generous retrenchment packages to placate workers, often at high financial costs to the state and taxpayers.²⁵

Consumers tend to be perceived as the silent majority who may lose out from privatization, particularly because of post-sale price increases in the services and utilities sectors. To the general public, price hikes after privatization stand out as the most tangible effect of ownership change and as proof of a negative effect. Although direct lobbying by consumers has been minimal in the absence of organized consumer groups, the media—a strong critic of the country's privatization process—has often taken up their case. However, either the users or the taxpayers (or a combination of the two) must pay for utility services. While antiprivatization complaints are often couched in terms of privatization's negative effects on the people as a whole, certain pricing regimes before privatization—LPG, for example—subsidized consumption of a small group of upper-income citizens at the expense of the overall society.

Despite negative media coverage, particularly during the second wave (which coincided with the free press becoming a reality in Sri Lanka), there is little commitment toward making the process more transparent or genuinely addressing equity concerns. The government's apparent willingness to sustain monopolies and impose regulatory restrictions hindering competition after privatization, as in the cases of SLT and Shell, perhaps suggest that the enormous prospects for rent extraction have not been lost on politicians and their favored supporters.

Nonetheless, one must consider the procedural political economy factors that have contributed to handing out exclusivity provisions and the underpricing of entities to be privatized. While such deals cannot be considered optimal, numerous harsh realities and difficult trade-offs confront government authorities in the reform and negotiation processes. Both Shell and telecom transactions, for example, were negotiated at a time when

25. In the case of the SLT divestiture, a unique and successful (in terms of worker cooperation) procedure was followed, whereby PERC informed workers' families about privatization's benefits directly.

terrorist attacks were rampant in the country. The dilapidated national airline had only three potential bidders, only one of which ran an airline. Government sales policy made it mandatory for all new owners of all privatized companies to provide ESOPs and retain all workers, at least for a time. These factors—imposed by the poor state of assets being sold and political and economic conditions outside the control of selling agents—limited the freedom to negotiate optimal sales.

Moreover, multinational companies often drove a hard bargain with developing country governments facing severe budget constraints and in dire need of foreign investment (partly to meet revenue generation goals imposed by international financial institutions [IFIs]). In return for commitments to invest, they demanded various exclusivities, barriers to entry, and pricing regimes that allowed them a substantial return on their investment. A case in point is the SLT privatization. The investor, NTT, laid out a range of choices for the government, whereby granting a three-year monopoly entailed an immediate and substantial price hike, while a five-year monopoly allowed for a more gradual tariff increase.

A closer look at the history of weak regulation that has paralleled the privatization process leads us to conclude that (1) the government deliberately decided to adopt a hands-off policy in order to attract private investment; (2) weak regulation allowed for rent-seeking behavior; and (3) the pace of privatization required by the IMF and World Bank did not allow for a proper sequence of events, whereby an effective regulatory framework would precede divestiture.

What is conspicuous over time is the privatization program's lack of ownership, with political leadership either reluctant to make tough decisions because of other political priorities (e.g., the need for coalition building), sending conflicting signals, or reversing or making ad hoc changes in the process entered into by a predecessor government. Such conditions provide fertile ground for vested interests intent on slowing, ending, or hijacking the privatization process or engaging in rent-seeking activities that deflect privatization's beneficial effects. To date, the most raucous opponents of the process have largely come from political parties outside the government. Despite all the opposition and negative press, the program has not provoked widespread social opposition, perhaps because those who stand to lose the most are the ones least able to voice their protests. Therefore, the question is: How long will it take for the process to backfire and for widespread social turbulence to make reform no longer possible?

Conclusion

What emerges from this analysis of Sri Lanka's divestiture program is that successive governments have not done enough to maximize distributional gains or minimize distributional losses that result from privatization. Overall,

the relatively poor have had little or no access to privatization's gains, while the well-connected (both local and foreign), who usually fall into higher-income groups, have benefited from increased rent-seeking opportunities under a nontransparent divestiture process.

The sincerity of the government's commitment to distributional ends appears questionable, as fiscal objectives and maximization of sales revenues through perpetuating monopolies under privatization agreements take priority over equitable asset distribution. Moreover, as the examples in this chapter illustrate, the government has displayed little genuine concern with regard to the lack of effective regulation after privatization and the prevalence of poor regulatory governance, which has facilitated rent-seeking activities in privatized entities.

Clearly, it is time to rethink and reorient privatization in Sri Lanka. If the process continues moving along the same path, the concept of privatization (as opposed to the way in which privatization has been implemented in the country) will be blamed for the socioeconomic problems of the poor. This outcome would be unfortunate, given that the alternative to privatization—return to a state-controlled system, with SOEs' high levels of inefficiency and rent-seeking opportunities—would not offer an improvement.

The issue, then, is how to make privatization work in an institutionally weak setting that lacks competition polices. More basically, how willing is the government to reorient the process, and what are the political incentives to do so. Until now, the political incentives to make the privatization process more equitable have been absent, and politicians have put distributional concerns on the back burner. However, the country's worsening macroeconomic condition and unstable sociopolitical climate suggest that the day of reckoning may not be far off.

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Appendix 12A

Company Descriptions

Sri Lanka Telecom. In August 1997, Sri Lanka Telecom (SLT) was privatized, with sale of a 35 percent stake in the company and a five-year period of management control to Nippon Telegraph and Telephone Corporation (NTT).

Sri Lankan Airlines. Sri Lankan Airlines (SLAL), formerly known as Air Lanka, was privatized in 1998. The strategic investor, Emirates International Airlines, was given a 10-year period of management control. SLAL is not a listed company.

Colombo Gas Company. Colombo Gas Company, Ltd. (CGCL), renamed Shell Gas Lanka, Ltd. (SGLL) after its privatization in 1995, provides liquified petroleum gas (LPG) to the country's domestic and industrial customers. The company is not listed. SGLL is the strategic investor and was given management control for five years.

Lanka Ceramics. Sri Lanka's ceramics industry has tremendous growth potential, given this industry's high level of expertise, abundant artistic talent, and 80 percent local availability of required raw materials. In 1992, Lanka Ceramics, Ltd. (LCL) was privatized, and was listed on the Colombo Stock Exchange the following year.

National Development Bank. In 1979, Sri Lanka's National Development Bank (NDB) was incorporated through an Act of Parliament, and was privatized and listed in 1993. The NDB aims primarily to promote economic development through the financing of medium- and long-term projects.

Bogawantalawa Plantations. Creation of regional plantation companies and privatization of their management in 1992 through competitive bidding was the first step in the privatization process. The strategic investor is Metropolitan Management Services. Bogawantalawa Plantations, Ltd. (BPL) is a listed company.

Caltex Lanka. Caltex Lanka, Ltd. (CLL) was formerly Ceylon Petroleum Corporation, the lubricating oil blending plant. In 1992, it was incorporated as a public company, and in July 1994, 51 percent of the company was sold to Caltex Trading and Transportation Corporation. CLL is a listed company.

Lanka Salt. In 1990, Lanka Salt, Ltd. (LSL) was incorporated under Public Companies Act No. 23 of 1987. The Employees Trust Fund Board bought 90 percent of LSL, and it was privatized in 1997. LSL is not a listed company.

Appendix 12B

Questionnaire for Data Collection

1. Income distribution:
 - What are Sri Lanka's income distribution trends?
 - What happened to the Gini coefficient over the last decade?
2. What state transfers and subsidies enabled SOEs to meet their debt obligations in 1990, 1994, and 2001?
3. Ownership issues:
 - What were domestic and foreign share ownership as a percentage of total privatized industries?
 - What was the percentage value of shareholders, based on regional and ethnic aspects?
 - Who bought more shares and benefited most: higher- or lower-income groups?
 - Did those who bought shares borrow from state banks or at market rates?
 - How open was access to shares?
 - What was the number of shareholders in each industry and total number of shareholders in the country?
 - Did resale of shares lead to consolidation of shares in the hands of a few?
4. Access issues:
 - What was the rate of access in selected industries several years before privatization and after privatization (what was the percentage of households with access)?
 - How has the rate of access changed after privatization of the firm?
 - How many consumers with informal connections were connected to the formal network after privatization?
5. What has happened to the quality of goods and services after privatization?
6. What happened to consumers' expenditure on utilities after privatization? Has it increased or decreased over time? What has been the effect on consumer welfare?
7. Firm efficiency and profitability data

8. Employee issues:

- How many workers were employed in the relevant sector before and after privatization?
- How has the real wage and job security changed after privatization, and what has the effect been on social security entitlements?
- What was the degree of overemployment (specific numbers)?
- How many employees were let go, and how many resigned voluntarily after the firm was privatized?
- Were they compensated? What was the firm's compensation procedure?
- Were new employees recruited?
- What steps has the company taken on behalf of employee welfare?
- Would employees have gained if they had held on to shares?
- What is the minimum wage? Labor productivity trends?

9. Divestiture pricing:

- What were stock market indices/valuations?
- Were shares underpriced?

10. Fiscal issues:

- How has the dividend yield changed over time?
- What were the taxation effects of divestiture?
- How much did the government earn each year through the privatization program? Did the program help to reduce the budget deficit? How did it affect the government's tax policy?
- What were the government gross receipts from these companies before privatization? Differentiate gross and net proceeds.
- Were the SOEs sold the more lucrative ones?
- What is the government cost of subsidized prices?
- Did the government acquire anything other than money in return for the sale of assets?