Research Paper

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Economic Reform in the GCC: Privatization as a Panacea for Declining Oil Wealth?

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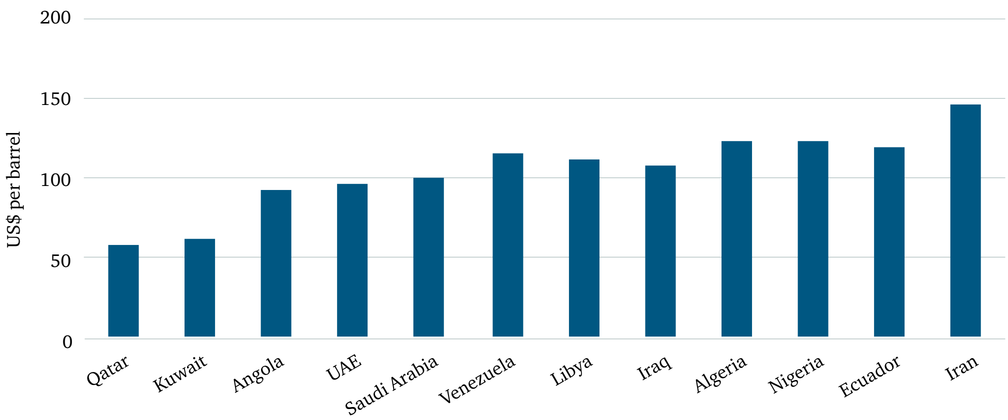
Summary

- The collapse in oil prices since 2014 has presented serious economic challenges for the countries of the Gulf Cooperation Council (GCC), underscoring the need to diversify their economies away from oil and develop their private sectors. In response, the GCC states have devised wide-ranging economic reform plans, central to which are, in many cases, options to privatize state-owned enterprises (SOEs).
- Media attention has focused particularly on the proposed sale of parts of Saudi Aramco, but across the GCC states the interest in privatization extends beyond energy to other areas of industry and services.
- Privatization, for the GCC states, is expected to create more effective incentives; force greater accountability on senior management; reduce government interference in business operations; and give management clear commercial targets unfettered by requirements of social policy. It is also intended to reduce the financial constraints on enterprises that have hitherto been dependent on government revenue.
- However, much of the current discussion disregards the lessons learned from privatization experiences elsewhere in the 1980s and 1990s. The very large literature developed at this time raises serious questions about the ability of divestment programmes to deliver the objectives now expected of the same process in the GCC.
- Analysis of the ideological arguments for privatization – derived from the economic theory of politics, theories of public choice and principal-agent analysis – can be used to explain why there is a strong possibility that governments in the GCC states will fail to privatize effectively.
- Previous experience shows that simply changing the property rights of an enterprise – i.e. switching it from public to private ownership – is not in itself sufficient to improve performance. This requires other conditions, including increased competition; improved signals that force management to be responsive, flexible and inventive; reduced government interference to allow management to maximize shareholder value; and effective and efficient capital markets to impose the necessary discipline on managers.
- The socio-political conditions that characterize the GCC countries – based on family and other elite patronage networks, and where property rights are dubious, the rule of law may be debatable, and the prospects for independent regulation of privatized enterprises are uncertain – are not conducive to enabling the necessary conditions for privatization to succeed.
- Economic liberalization through privatization is unlikely to succeed in the GCC states without simultaneous political liberalization and reform. If privatization simply delivers a set of windfalls for the state while reinforcing traditional patronage networks, this is likely to aggravate the same perceptions of corruption and helplessness that triggered the Arab uprisings from the start of 2011.
- Theory and contextual analysis alike therefore suggest that privatization will not be the panacea that many believe it to be for the GCC states. A process that allows the entry of the private sector and thus forces a (hitherto monopoly) SOE to compete and perform appears to be a more realistic way forward than does wholesale privatization.

Introduction

The collapse in world oil prices since mid-2014 has reinforced two imperatives for the countries that make up the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE. First, there is the need to raise revenue in order to balance state budgets. Figure 1 illustrates the estimated budget break-even prices for the OPEC countries shortly before the price began to slide. The weighted average was $102 per barrel.

Figure 1: OPEC median budgetary break-even price, US$ per barrel, as at August 2014



Source: Ali Aissaoui, Apicorp Economic Commentary, 9(708), July–August 2014.

Since November 2014, when OPEC decided not to act to defend prices, estimates published by the US Energy Information Administration show that the average price of West Texas Intermediate (WTI) has been $47 (to October 2016). Evidently, more revenue must be raised if spending commitments are to be realized. Since 2011, moreover, in the wake of the Arab uprisings, governments in the region have come to consider an inability to buy off domestic political discontent arising from lower spending as potentially representing an existential threat.

The second imperative has been the strengthened focus on the understanding that diversification of the GCC economies away from dependence on oil is both essential and long overdue. As part of this is the promotion of the private sector as a generator of both tax revenues and employment especially for the large numbers of young people entering the jobs market, and as a means of mitigating vulnerability to volatile oil prices.

Thus, many of the GCC governments have been discussing and attempting to promote economic reform, with a particular emphasis on the need for wide-ranging privatization.[1] Probably the highest-profile effort has been the National Transformation Program (NTP) launched in Saudi Arabia in April 2016 as part of the implementation framework for Vision 2030 (Kerr, 2016a). Saudi Arabia has past experience of partial privatizations, for example SABIC (Saudi Arabia Basic Industries Corporation, one of the world's largest petrochemicals manufacturers) in 1985 and Saudi Telecom in 2002.

[1] The term 'privatization' can be used in many different ways, but in the context of this paper it is defined simply as the selling of existing state-owned entities into the private sector, whether domestic or foreign. Among the GCC states, a range of other mechanisms are being considered to increase the role of the private sector in the economy, including build–operate–transfer (BOT), management contracts, and opening restricted sectors to private investment through public-private partnerships; however, such options are beyond the scope of this paper.

However, the strategy now outlined in Vision 2030 seeks to take this further, even extending to Saudi Aramco.[2] As noted by the IMF in May 2016:

> Vision 2030 sets out the goal of an appropriately bold and far-reaching transformation of the Saudi Arabian economy to diversify growth, reduce the dependence on oil, increase the role of the private sector, and create more jobs for nationals …
>
> … To increase the role of the private sector in the economy, as envisaged in Vision 2030, privatization and PPPs and reforms to further strengthen the business environment, attract foreign investment, and encourage the development of the capital markets will be important (IMF, 2016a).

In anticipation of an extension of the privatization programme, the Capital Market Authority and Tadawul (the Saudi Stock Exchange) have recently relaxed restrictions on foreign investment in Saudi-quoted stocks (MEES, 2016a). There are 20 references to privatization in the NTP,[3] although it should be noted that no specific claim is made in the text that privatization will resolve all of Saudi Arabia's economic problems. However, the Saudi government's first international bond prospectus, launched in October 2016, does state that the privatization programme is an important part of its strategy for realizing economic development, enhancing the performance of companies and improving the standard of services. It is also aimed at improving the financial efficiency of these companies, reducing administrative burdens, increasing economic growth and enlarging the ownership base in Saudi Arabia, in addition to attracting foreign investment.[4]

Elsewhere in the Gulf, Kuwait's cabinet has approved a plan that will boost private sector participation to 40–50 per cent in public-private joint ventures. It also intends to promote public-private partnerships by allowing the private sector to acquire shares to the value of KD2.7 billion ($9 billion) in public-sector firms including airports, ports, power plants and (unspecified) parts of the Kuwait Petroleum Corporation (MEES, 2016b). Qatar's ruler, Sheikh Tamim bin Hamad Al Thani, was reported in late 2015 to have warned against wasteful spending, overstaffing and a lack of accountability, and as well as against citizens' over-reliance on the state. The budget for 2016 was intended to focus on efficiency in government spending, and to promote growth in non-oil sectors. Following a review of subsidies to state-run companies, Sheikh Tamim was reported to have ordered the halting of subsidies to some companies and the privatization of other enterprises (MEES, 2015a).

In the UAE, *Gulf News* reported almost a decade ago that the cabinet had approved the privatization of the country's utility sector, involving the sale of assets belonging to the Federal Electricity and Water Authority (FEWA) (Rahman, 2007). More recently, Dubai's ruler, Sheikh Muhammad bin Rashid, announced in February 2016 that plans were being prepared for the privatization of most of the UAE's services as part of the transition to a post-oil economy (Allam, 2016). Oman, for its part, has announced plans to privatize a number of companies, among them ORPIC (the refining and petrochemical division of the Oman Oil Company – OOC), Oman Gas Company (in which OOC holds a 20 per cent stake), the drilling services firm Abraj Energy, and Oman Trading International (OTI), which *inter alia* handles the country's crude oil (MEES, 2015b).[5]

[2] Media attention has focused particularly on the proposed sale of parts of Saudi Aramco, but the interest in privatization extends to other energy companies and to other sectors of the economy. As regards Saudi Aramco itself, at this stage it is not at all clear what 'privatization' would entail. Talk has been of selling off 5 per cent, but 5 per cent of what is not clear.
[3] The full text of the NTP is available at http://vision2030.gov.sa/sites/default/files/NTP_En.pdf (accessed 20 November 2016).
[4] In October 2016 the IMF published a report (IMF, 2016b) that presented a very positive picture of what privatization would bring to Saudi Arabia's economic performance. However, it rather neglected to consider many of the problems likely to arise with privatization arising from the socio-political context of Saudi Arabia, discussed (with reference to the GCC states generally) in this paper.
[5] Established as a joint venture between OOC and the international trading giant Vitol, in November 2015 Vitol's shareholding in OTI was transferred to Oman's State General Reserve Fund: see http://www.omantrading.com/oti-becomes-100-percent-government-owned.

Many advocates of such economic reforms apparently regard privatization as a panacea that will unquestionably reverse the fortunes of the oil-dependent GCC economies, solve their budgetary problems and promote economic diversification.[6] The purpose of this paper is to consider the extent to which, in practice, privatizations in the GCC countries may be able to deliver the objective of promoting economic transformation.

What do the GCC states expect of privatization?

In the context of the GCC, the rhetoric suggests that privatization is intended both to improve an enterprise's performance,[7] and to improve the nation's economic well-being – not least by raising revenue for the government. It is important to note, however, that a privatization programme may have many other objectives, apart from improving enterprise performance (Stevens, 1993). Tellingly, the economist John Kay cites the response of a senior British civil servant when asked what the motives were for privatization:

> The mistake in that question is to suppose that privatization is actually about anything. It is a political imperative pursued for itself. If any argument for it can be found, or any benefits from it can be perceived, a grateful government will seize on them as rationalization; these are not objectives. The policy is the policy because it is the policy. There is fundamentally no more to it than that (Kay, 1985).

Assuming, for the purposes of this paper, that the primary objective among the GCC states is improved enterprise performance in conjunction with raised revenue, the rationale for privatization – as distilled from the literature (Stevens, 1997) – can be summarized as follows:

- **State-owned enterprises (SOEs) are intrinsically inefficient**, and simply changing the property rights will therefore lead to improved performance.
- A **privatized entity provides better incentives for management** (both carrots and sticks) to drive a better performance.
- **Privatization forces greater accountability on senior managers**, thereby overcoming a key problem in SOEs arising from asymmetry of information associated with the economic concept of principal-agent analysis (see Box 1).
- **Privatization gives an enterprise clear and unequivocal targets**, i.e. maximizing shareholder value; hence the privatized enterprise is no longer required to act as an instrument of the government's social or regional policy.
- **Privatization reduces the financing constraints on SOEs**, meaning that a lack of finance resulting from existing chronic budget deficits would be remedied by means of access to capital markets both at home and abroad.[8]

[6] Attending a conference in Oxford in June 2016 where these issues were being discussed and privatization was being touted as the solution, the author was struck by the nature of the arguments being used to justify privatization in the GCC, which were identical to the sorts of arguments used in the 1980s and early 1990s to justify programmes of privatization, particularly in the UK. It appeared much of the audience was unaware that these issues had been widely discussed at that time, and that many of the current assertions regarding the benefits of privatization are without merit or, at best, very debatable. In 1997 the author published an article (Stevens, 1997) challenging many of the arguments for privatization in the context of the energy sector in developing countries. Since many of the arguments used in that article are relevant to the current enthusiasm for privatization in the GCC, this paper is intended to serve as an updated version that may dissuade participants in the current debate from reinventing the wheel.
[7] Measures of performance can range from, *inter alia*, a business's profitability to its service quality to its contribution to diversification.
[8] The author is grateful to the reviewer who pointed out that in the GCC states, opening up infrastructure to private investment has also been a perceived contribution of privatization, and that relying on private funds rather than oil revenues protects projects from volatility in oil markets; nonetheless, it is well established that volatility in government revenues seriously affects private-sector finances, given the dominance of government-funded projects as well as lower oil prices leading to non-payment of bills.

It is important to examine how privatization alone is expected to produce these benefits. Three areas of economic theory emerged in the 1970s under the generic term 'government failure' (briefly outlined in Box 1), setting out the case for why simply changing the property rights may be the key.

Box 1: The concept of 'government failure'[9]

The role of government intervention in an economy has had a distinctly cyclical nature. The 25 or so years after the Second World War were characterized by large-scale state involvement in nations' economic systems. It was widely held that governments could and should intervene directly to address social and economic problems. Furthermore, there was general acceptance of the existence of 'market failure' – i.e. imperfect competition arising from the presence of monopoly power and asymmetric information; the presence of ownership externalities – costs and benefits accruing to society but not to the owner of the factors of production employed (land, labour, capital and entrepreneurship); and the existence of public goods whereby consumption was non-rival and exclusion from access technically infeasible. Solutions to these problems of market failure lay in government intervention by means of corrective taxes and subsidies, regulation, price controls, planning, and ultimately government ownership.

During the 1970s, the intellectual underpinnings of what had previously been largely unchallenged views supporting state intervention came under attack from three areas of economic analysis:

The first of these, the economic theory of politics, examined politicians' behaviour as it relates to their interaction with their constituents. The second, theories of public choice, applied economic theory to the behaviour of bureaucrats and how their maximizing behaviour influences the allocation of resources (Niskanen, 1971; Tullock, 1965), with the conclusion that rent-seeking behaviour[10] will inevitably cause public-sector provision to be inefficient.[11] The third area was the work on what was termed principal-agent analysis (Vickers and Yarrow, 1988), the basic construct of which is that information as to the true costs of an operation lie with the bureaucrat (the agent), while the principal (the politician) has no mechanism to monitor the agent's performance. Under this analysis, the agent is able to absorb any consumer surplus despite the principal's interest in keeping down the costs of provision for purposes of garnering popular support. The process of privatization is thus supposed to enable the stock market to impose discipline on the agent through the provision of benchmarking designed to overcome information asymmetries.[12]

All three schools of theory identified the fact that government intervention in the economy would lead to a misallocation of resources – so-called 'government failure' – a common view that coalesced during the 1980s into what came to be (disparagingly) called the 'Washington Consensus'. In the context of the debt crisis, the IMF and the World Bank, as the principal evangelists for this consensus, were in a uniquely powerful position to impose a view that favoured privatization, deregulation and general liberalization. With the collapse of the Soviet Union, the model appeared complete. State-owned enterprises were regarded as dinosaurs in need of a helping hand towards extinction, with reduced state intervention – not least by means of privatization – an undisputed requirement for economic transformation.

Beyond changing property rights, if the other contributions of privatization listed above are to be effective in improving an enterprise's – and an economy's – performance, privatization alone is insufficient. Other conditions are required, the first being increased competition facing the newly privatized entity. Competition fulfils two functions. It forces enterprises to seek to operate at lowest possible cost, thereby promoting productive efficiency; high-cost operation will make an enterprise

[9] The contents of this box draw on work previously published by the author (Stevens, 1997).
[10] Rent-seeking behaviour is when the management of an institution absorb that institution's resources for their own benefit. A classic example is from the UK civil service, where it used to be said that it was possible to determine the seniority of an individual by the thickness of the carpet in their office.
[11] There is much debate as to whether such inefficiency constitutes allocative or productive inefficiency (Jackson, 1982; Peacock, 1992).
[12] One of the reasons why the 2001 Enron scandal was such a shock was that it drove the proverbial 'coach and horses' through one of the founding ideological principles underpinning privatization.

vulnerable to new entrants that are able to capture market share by virtue of lower costs leading to lower prices. Competition also squeezes out supernormal profit as price falls to equality with marginal cost, thereby securing allocative efficiency.

The second condition is improved signals that, it is claimed, force management to be responsive, flexible and inventive. These signals can be categorized in terms of both the input and output prices facing the firm, and the incentives that apply to managers. As regards prices, these should be such that the 'bottom line' becomes a real and meaningful figure, with success defined as maximizing shareholder value. Incentives for management can be viewed as carrots and sticks to reward good performance and punish poor performance, thus requiring an ability to make extra payments and to sack anyone at any time.

The third condition is reduced government interference in the running of an enterprise. This removes other objectives from the remit of the enterprise that may be related to wider social or regional policy, and also allows management to respond to the objective of maximizing shareholder value.

The fourth condition is effective and efficient capital markets to impose the necessary discipline on managers. If the latter fail to maximize shareholder value, then shareholders, observing this poor performance in terms of lower dividends in relation to other shares, will begin to sell their stake. This pushes the share price down, thereby reducing the wealth of remaining shareholders, who will in turn either sell, thus aggravating the problem, or seek to exercise their (at least theoretical) right to remove the existing management. Continued poor performance results in takeover or in bankruptcy;[13] in either case, the incumbent management is usually dismissed.

Of far greater relevance to performance is the context in which the enterprise operates; in particular, the local political economy is crucial, and the presence of competition is key.

The results of the large body of empirical work aimed at testing the hypothesis that changing the property rights enhances performance are far from decisive.[14] One interpretation of these contradictory and inconclusive results (Stevens, 1997) could be simply that more testing is required. However, an equally valid conclusion, given the large number of studies now completed, is that the nature of ownership of an enterprise in itself matters little to its performance. Of far greater relevance to performance is the context in which the enterprise operates; in particular, the local political economy is crucial, and the presence of competition is key. An SOE operating in a competitive context is likely to perform just as well as a privately owned company, whereas a privately owned monopolist or cartelized oligopoly is likely to perform badly. Therefore, the necessary conditions for privatization to improve performance are: operating in a competitive environment; improved signals to management; reduced government interference; and access to efficient capital markets.

[13] Former astronaut Frank Borman once remarked, as chairman of Eastern Air Lines, that capitalism without bankruptcy would be like Christianity without hell.

[14] The debate has generated increasing amounts of empirical studies to examine the relative performance of private versus state-owned enterprises. Indeed, the subject could be said to provide an ideal topic for a PhD thesis, given its large literature, growing developments in measuring techniques (e.g. data envelope analysis), and the ability to make an original study at a highly specific level.

Can the necessary conditions for privatization to improve performance be met in the GCC?

In the current context of the GCC countries, the prospects of achieving the necessary conditions for privatization to be effective are unlikely to be present.

Governments will continue to intervene

Despite their stated position of favouring market forces and the private sector, GCC governments have a long history of strong and unremitting intervention in their economies, if only to achieve important public policy and development objectives. Many of the SOEs now likely to be targeted for privatization are related to energy (Hertog, 2013).[15] As such, these companies are extremely important strategically, whether considered as supplying a factor input, as an input into standards of living, or as a source of foreign exchange or government revenue.

In these circumstances, it is inconceivable that any government would cease to intervene in the sector, irrespective of where ownership lies. For example, the loss of electricity in households can be a major source of embarrassment for any administration. Furthermore, the energy sector tends to be characterized by very significant economies of scale, scope and density,[16] meaning that activities tend to be large and highly capital-intensive. This carries two sets of eventualities. First, an enterprise may be too large for the local capital market to take on. Likely buyers would be either very rich nationals or foreign companies. Purchase by the former would have serious implications for concentration of economic and thus political power.[17] As regards the GCC economies specifically, it is also worth pointing out that the distinction between the private and the public sectors is far from clear, given the very strong links that exist between the ruling families and the major merchant families (Crystal, 1995; Kamrava et al., 2016).[18] Purchase by foreign companies may raise issues of nationalism. Second, because of the scale of energy sector enterprises in relation to the total market, even in the absence of any legislative barrier to entry, the incumbent enterprise would in some cases remain a natural monopoly based on size. The introduction of competition would therefore be extremely difficult, notwithstanding the contestable market hypothesis.[19]

Another factor that would make it difficult for GCC governments to reduce intervention concerns employment. A key objective of economic policy for all the GCC governments, but especially for Saudi Arabia, has been job creation for the growing number of unemployed young nationals. To this end, SOEs have come under enormous pressure to take on more nationals. Under private-sector ownership, it is difficult to see why these businesses would be willing to maintain a typically oversized, predominantly local labour force, or indeed be willing to employ more young workers – especially if these are the product of an education system commonly regarded as dysfunctional, as is the case

[15] Most of the analysis in this paper concerns privatization in the energy sector. Arguably, privatization in sectors such as banking, telecoms, industry, health and education, also much discussed in the GCC, may well present different challenges. Also there has already been considerable privatization in electricity and water and downstream oil and petrochemicals.

[16] An interesting exception to this arises because of developments in combined cycle gas turbine (CCGT) technology, where economies of scale in generation are very much less than in the case of traditional thermal or primary stations. Similarly, renewables tend to be small scale and decentralized. It remains to be seen how far CCGT and renewables may modify the following arguments in the future.

[17] This is especially important where privatization might serve to promote political patronage (see below).

[18] The author is grateful to the reviewer who noted that this is often seen in the interlocking structure of corporate boards featuring both business families and members of the ruling families in an ostensibly 'private' capacity.

[19] First developed in the early 1980s (Baumol, Panzar and Willig, 1982), this hypothesis argues that it is not necessary to have a large number of suppliers to create competition. The threat of 'hit-and-run' entry would produce the same behaviour in incumbent firms as a market with a large number of suppliers. However, contestable markets require low entry and exit costs, neither of which are characteristic of conventional energy enterprises.

in Saudi Arabia.[20] The goals of privatization and 'Saudiization' would not appear to be generally compatible.[21] Already, there are tensions between business communities and governments in the GCC states over measures intended to limit the supply of cheap migrant labour and in effect increase salary costs by employing more nationals. Such disputes are likely to worsen in a context of privatized entities creating greater competition – a scenario that would be likely to drive deeper cost-cutting, and an emphasis on an economic rather than a socio-political rationale.

'Correct pricing' remains a serious challenge

Energy sector prices in the GCC states also present difficulties as regards providing better signals for management. The production and consumption of energy are inseparable from their environmental consequences. Given such externalities, governments have a clear responsibility to intervene, either by means of taxes – including by imposing taxes on a polluter – or subsidies, or by otherwise internalizing the externalities. The notion of market forces determining prices wholly free from government intervention is neither feasible nor desirable. More specifically, most GCC governments have used domestic energy pricing as a tool of social policy and income redistribution, with, in many cases, prices of electricity and oil products set well below border prices. Trying to charge more realistic prices presents many challenges, especially in terms of their political acceptability (Lahn and Stevens, 2011; Stevens and Alyousef, 2011), although many GCC governments have been increasing prices in 2016. In the case of Saudi Arabia, increased prices for energy and utilities introduced through subsidy cuts under the 2016 budget appeared initially to be accepted by consumers, although the water and electricity minister was dismissed in April, apparently in response to public complaints about tariff rises for water. At the time of writing, moreover, the full impact on household bills during the summer period, when consumption of both water and electricity rises significantly, was not yet known.[22]

The efficiency of capital markets

Regarding the fourth condition for privatization to work – effective capital markets to impose the necessary discipline on managers – stock exchanges in the GCC states have historically been far from efficient, and have been notorious for extreme volatility. As noted in one commentary:

> … in the absence of oversight and accountability, privatization leads investors … to lose money … There are cases where manipulation and corruption plagued joint-stock companies on the Saudi stock market amid the lack of oversight and accountability, which led many citizens to lose money while only a handful of senior owners and directors made gains (Rabian, 2016).

It is therefore very doubtful that these institutions could create an environment in which privatization generates improved performance. While many GCC governments are trying to improve the performance of their capital markets, not least by encouraging greater participation by international investors with the expectation that their involvement can help to impose better corporate discipline, it will take some time for this to have a sustained positive impact.[23]

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[20] For example, one survey published by the OECD in 2015 ranked Saudi Arabia 66th out of 76 countries in terms of educational systems; this is despite the large amount of resources dedicated to education in the kingdom. See Hanushek, E. and Woessmann, L. (2015), *Universal Basic Skills: What Countries Stand to Gain*, Paris: OECD Publishing, http://www.oecd.org/edu/universal-basic-skills-9789264234833-en.htm (accessed 20 November 2016).
[21] It should nonetheless be noted that in Saudi Arabia private-sector employment of Saudi nationals has in recent years been rising faster than in the public sector. Furthermore, the majority of Gulf nationals are employed in government administration and security services rather than in SOEs. Nonetheless, it is within the private sector that GCC governments are looking to employ nationals.
[22] There are indications that popular unrest in Saudi Arabia may be growing as a result of the economic reforms (Kerr 2016b).
[23] A more immediate reason to encourage international investors is to reverse the capital outflows that in many cases are threatening the dollar peg on which the GCC states' exchange rates are based.

The nature of privatization targets

The conventional energy sector tends to be associated with projects that have long lead times and long payback periods. It is therefore valid to question the extent to which reliance on capital from private sources – through equity or borrowing – can provide the capacity needed to (literally) keep the lights on and the air conditioning working in a context of short-termism in capital markets. If shareholders are only interested in the next quarter's dividends, they are unlikely to be sympathetic to investment in the sort of long-term projects that are characteristic of much of the energy sector.[24] Furthermore, market forces imply free entry and exit. For example, operators that fail to make their required rate of return will typically withdraw and put their resources elsewhere. If such a withdrawal means that the lights go out, it is inconceivable that any government would allow energy sub-sectors to wither away for lack of capital or simply dismiss supply shortages as the working of market forces.

The theoretical arguments for privatization also explain why GCC governments will fail to privatize effectively

Much of the theory used to argue for a limited role of government in the economy (as summarized in Box 1) can equally be used to make the case that governments will in reality make a mess of the process of exit (i.e. privatization), with the result that the necessary conditions to improve performance will fail to emerge. Such failure in the privatization process itself is likely to be more pronounced in the GCC, where checks and balances are weaker than those of other economies that have followed the privatization route.

Subscribers to the concept of 'government failure' have been a highly powerful force in providing an intellectual basis for the drive to privatization – as was particularly true in the UK in the 1980s under the government of Margaret Thatcher. To summarize: government intervention distorts, therefore the solution is to remove government intervention from the loop. However, the same arguments can equally be used to explain why, during the process of privatization, a government is likely to behave in such a way that the necessary conditions for privatization to make a positive contribution are unable to emerge.

The theory runs that politicians have a vested interest in selling an enterprise as a monopoly – either because, in anticipation of supernormal profits, a monopoly is easier to sell, or because a monopoly will sell for a higher price. Similarly, the existing management will have a strong interest in the enterprise being sold as a monopoly. This enables management to continue rent-seeking behaviour, but with much greater prospects of direct (personal) financial gain. The attitude of the existing management is important, since there is a widespread view that the presence of information asymmetries – i.e. existing managers are the only ones with the information required to successfully float the enterprise – means that full cooperation from management is essential for a privatization to succeed. The arguments explaining monopoly sale as a high probability are reinforced if the privatization is aimed at providing political patronage for family, supporters or tribe.

[24] In the GCC this argument is reinforced because the private sector is dominated by merchants who traditionally tend to have shorter time horizons when investing (Crystal, 1995; Kamrava et al., 2016). However, it is worth pointing out that many electricity and water projects have been financed since the mid 1990s through project finance facilities and equity from capital markets, although there has been strong residual state role in the financing.

If an SOE is sold as a monopoly, competition – a key condition for successful privatization – is much less likely to emerge in the absence of other, powerful facilitating policies.[25] In the GCC states, where there tend to be very strong links between economic and political power (Crystal, 1995; Kamrava et al., 2016), such policies are unlikely to emerge, with the result that the incumbent will be able to behave in a predatory manner to ward off potential entrants. Moreover, the sale of an SOE as a monopoly implies that improved signals to management – another necessary condition for improved performance – are less likely to ensue. Sales prices can remain unjustifiably high, and indeed can go higher driven by pure profit motive, while input prices, themselves often subject to monopsonist power,[26] are also likely to remain distorted. If monopoly status is retained, this could inhibit a reduction in government intervention – a further necessary condition for privatization to work – as governments struggle to offset the distorting effects of a monopoly through regulation.

> In general in the UK, all the mistakes that could be made for reasons of narrow self-interest were made. An instructive example is that of British Gas, which was privatized in 1986. The ideology that drove the Thatcher government meant it genuinely believed that all it had to do was change the property rights.

The evidence from the UK experience of privatization very strongly supports this counter-case (Mackerron and Pearson, 1996). In general in the UK, all the mistakes that could be made for reasons of narrow self-interest were made. An instructive example is that of British Gas, which was privatized in 1986. The ideology that drove the Thatcher government meant it genuinely believed that all it had to do was change the property rights. In other words, transferring the enterprise to the private sector would automatically improve performance. A state-owned, vertically integrated monopoly and monopsony was thus converted to become a privately owned, vertically integrated monopoly and monopsony, with the result that, under private ownership, a powerful incumbent was able to use its control of the gas supply grid to limit competition from new entrants. It took more than 10 years to sort out the mess. While the process might eventually have led to a 'better' gas sector in the UK (defined in terms of improved productive efficiency), the process was little short of a shambles. When, in 1990, the electricity sector was privatized, the government did draw on this lesson from British Gas, separating the electricity supply grid to form a separate company. However, since the aim was to raise as much revenue as possible from the sale, the government then split generating operations to be privatized into two large companies to make them more attractive to investors. Not surprisingly, this duopoly also failed to generate genuine competition. If this has been the experience in an apparently advanced and relatively well-informed democracy, what chance is there for a successful process under the existing governments in the GCC?[27]

A quite different example comes from Russia, where the presence of adverse institutions in a series of 'voucher privatizations' in the early 1990s led to the strengthening of monopolies and patronage. Under this process, voucher 'shares' in state-owned companies were distributed to employees and the general public. However, most recipients promptly cashed in their vouchers,[28] which came to be

[25] At the moment there appears to be no plans to sell entire enterprises. Rather, it is proposed to sell minority stakes. However, this could change as the financial pressure on government budgets grows.
[26] In effect, in a market in which there is only one buyer.
[27] On a more positive note, many lessons have been learnt from the UK experience, not least in the context of unbundling vertically integrated companies in order to promote competition.
[28] A notable side-impact of these rapid swaps, arguably symptomatic of the impoverishment of the population through the process of economic and political transition, was an increase in consumption of vodka and patronage of brothels in Russia at this time.

accumulated by the country's oligarchs. The end result was an enormous concentration of economic power in a few hands, even though the original intention behind the voucher scheme had been to avoid control of the privatized assets by the oligarchs.

There is a further dimension related to politics. What progress occurred after privatization in the UK, for example, has chiefly resulted from the independence and the aggression of regulation. While regulation in the UK has been somewhat ad hoc, often ill informed and at times of patchy quality, it has at least been largely independent. The regulators' competence may at times be questioned, but not their integrity or their ability to be independent. In the political systems of the GCC, such a state of affairs is unlikely to take hold. SOEs may be costly and inefficient, but, in the absence of effective regulation, privately owned monopoly enterprises will be far worse for the consumer and will be unlikely to promote the key objectives of improved economic performance and diversification away from dependence on oil.

In countries in which government is characterized by a monopoly of power associated with family, sect or tribe, the inevitable intrusion of political patronage is liable to render the provision of the necessary conditions for privatization to improve performance highly unattainable. Political patronage is not conducive to competition, whereas it is likely to encourage government interference to secure significant advantages to the enterprise – not least protection from failure. Transparency is also an unhappy bedfellow of any monopoly of power.

Conclusions

Summary table: The barriers to effective privatization in the GCC states

What privatization is supposed to offer	Barriers in the GCC
'State sector bad, private sector good'	Competition will not appear if the elites buy the enterprises; governments may sell as a monopoly, and large incumbents will inhibit new entrants
More effective incentives for management	'Government failure' will make it likely that exit will be messed up
Greater accountability forced on management	Governments will not allow strategic industries to fail
Reduced government interference, providing management with clear performance targets	Ineffective and inefficient capital markets are likely to be dominated by short-termism
Reduced financial constraints on management	Reduced government interference is unlikely: energy is a strategic sector, and there are objectives concerned with creating employment
	Serious price reform is needed
	Sell-off targets may be too large for domestic capital markets
	If only the ruling elites benefit, this will fuel unrest

Theory and contextual analysis alike suggest that privatization will not be the panacea that many believe it to be for the GCC states. As summarized in Table 1, the necessary conditions for privatization to succeed are unlikely to be present when and where they are needed. Furthermore, the local private sector in the GCC possesses limited technical and managerial capacity (Hertog, 2013), meaning that handing over state-run assets could well backfire in terms of competence and planning capacities for these entities. Finally, analysis for the CFA Institute has noted that divestments will not necessarily result in a redistribution of wealth to citizens. Indeed:

> Governments in the region are already important shareholders in public equity markets as a result of previous privatizations and active investments made by a range of sovereign investors (such as social security and sovereign wealth funds) …[S]overeign investors own over 40% of overall MENA markets' total capitalization, and these figures are even higher in the Gulf (Amico, 2016).

Some have made the case that there is an alternative way forward, as is best expressed in the argument that privatization is in itself a slogan, whereas the true critical factors are economic reform and liberalization (Aylem, 1985). The argument is that for at least three of the necessary conditions for improved performance, as discussed above, privatization is not required. Greater competition, better signals and reduced interference can all be achieved through a process of deregulation and liberalization. A process that allows the entry of the private sector and thus forces a (hitherto monopoly) SOE to compete and perform certainly appears to be a more realistic way forward than does wholesale privatization.

It is interesting to speculate about the risks of getting privatization wrong in the GCC. A privatization programme that simply delivers a set of windfalls for the state while reinforcing patronage networks through rent-seeking by the traditional family elites is likely to aggravate the same perceptions of corruption and helplessness that triggered the Arab uprisings from the start of 2011.

This is precisely the sort of reaction that the current reform programmes in the GCC states are intended to prevent, not least through the expectation that the private sector will create jobs and increasing living standards. In the GCC context, however, a key problem remains in that incumbent governments dominated by family, tribe, clan and other elites will not be inclined to encourage a flourishing domestic private sector outside their close control. At present, the private sector in the GCC is dominated by ruling families or businesses operating under their patronage. In the Arab states generally in the 1950s and 1960s, the private sector was systematically dismantled by new 'revolutionary' governments in order to undermine the economic and hence political power of the old political elites (Owen, 1992). The question arises as to whether real economic reform can occur in the GCC states without real political reform. To use the jargon of the debate that took place in the final years of the former Soviet Union, is perestroika (economic restructuring) possible without glasnost ('openness', or more specifically political liberalization)? For the GCC, the answer is likely to be no. In the absence of meaningful political reform, even the most elementary moves to economic liberalization, let alone the complex and difficult processes of privatization, are very likely to fail. It is intended that this paper, in revisiting the arguments that have circulated during earlier pro-privatization cycles, will inform a more nuanced discourse in the GCC, and thus foster a more effective set of policies to address the very clear and immediate difficulties for member states in balancing their budgets and diversifying their economies away from reliance on oil revenues.

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Image: A Saudi investor at the Tadawul (the Saudi Stock Exchange) in Riyadh, on 15 June 2015.

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