ENTRY, EXIT, EFFICIENCY & THE QUESTION OF PRIVATIZATION:
THE CASE OF BANGLADESH

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ABSTRACT

In most industries, there is a fair amount of entry and exit. Although there are many new entrants in a given industry, most firms do not succeed and are forced to exit. Only few firms manage to survive and grow. The findings of Binayak Sen’s (1997) recent survey of privatized firms in Bangladesh are interpreted in light of the industrial organization literature on entry and exit. The large number of closures and the change of firms’ activities are not necessarily symptoms of the failure of the privatization program. Such events take place as firms evolve over time. (JEL L33)

Keywords: Bangladesh, Entry, Efficiency, Exit, Privatization, Industrial Organization
Introduction

This paper relates the issue of privatization of public enterprises (that is, the transfer of ownership and control of state owned firms to the private sector) with firm’s entry, exit, and efficiency. The first section provides an overview of firm entry and exit and briefly reviews the empirical findings in industrial organization literature concerning firm entry and exit. The second section presents the findings of Sen’s (1997) survey of privatized firms in Bangladesh and interprets it in light of industrial organization literature.

[1] Entry and Exit

Entry and exit of firms are an indispensable part of the evolution of an economy’s industrial structure. Some firms enter an industry by either buying or building new plant and equipment. Some firms buy up other firms’ existing plant and equipment. Other firms switch from one industry to another by converting its existing plant and equipment, with some additional investment if necessary. New firms are generally much smaller than incumbent firms, and start with much less capital. Existing firms expand in many different ways. Some firms acquire other firms in the same industry. Some firms increase their market dominance and increase their level of investment. Some firms expand vertically, some horizontally, while others in both ways, through mergers and acquisitions. A few firms, investing in an array of activities, become conglomerates.
Firms that are unable to adapt to changes in economic conditions fail to earn profits. Thus, while robust and dynamic firms thrive and grow, weak firms fail because of poor and incompetent management, inappropriate choice of technology and technique, and inability to satisfy consumers. The survival of a firm may be linked to its current profits and lagged profits, sales, the industry’s current and past growth, and so forth. Large incumbent firms often have an edge over entrants due to economies of scale, product differentiation, and absolute cost advantages.

Suppose the entry-inducing price is $P_E$ and the competitive price is $P_C$. Then the entrant would bear the cost $\rho = P_E - P_C > 0$ which an incumbent would not. This gives such incumbents a clear and distinct advantage.

Empirical studies of entry and exit of firms are quite illuminating. Dunne et al (1988) examines the pattern of entry and exit in US manufacturing industry. They find that entrants average about 39 percent of the number of firms per four-digit manufacturing industries. The market share of such entrants averaged merely 16 percent. From one census year to another about 30 percent to 40 percent of firms exit from business. The average size of such firms is about one third of the firms that remain. Schwalbach’s (1991) analysis of German manufacturing industry shows that the average number of entrants per year is nearly 12 percent of the number of firms per industry. On average entrants are much smaller than incumbents in terms of market share and sales. Exit data show that on average 14 percent of the number of firm per industry leaves each year. The typical exiting firm is much smaller than the firms that survive. Entry and exit in industry groups are correlated. Geroski’s (1991) study of entry and exit data from the United Kingdom;
and Baldwin and Garecki’s (1989) study of such Canadian data show similar results.

The large number of new entries in an industry and their subsequent failure is indicative of the inability of most entrant firms to correctly assess their actual and future market conditions. Thus, the entrepreneur’s expectation of profitability seems to be systematically higher than what is realized, and indeed what is realizable. The persistence of such trends lends credibility to bounded rationality view rather than rational expectations view of the firm.

In most industries, entry and exit occur simultaneously. Of the many firms that enter an industry, only a select few manage to survive, grow, and flourish, while the rest perish. Such high volume of firm extinction does not deter new firms from entering in most industry.


Results

Bangladesh Institute of Development Studies’ (BIDS) survey of privatized firms in Bangladesh, conducted under the direction of Binayak Sen (1997), catalogues the post-privatization status of 205 firms, reporting in particular their current operational status, the transformation of their activities, and the effect on labor retrenchment.

A key finding of the survey is that there has been a noticeable change in the pattern of ownership. Approximately 26 percent of the firms are now under new ownership, unrelated to the owners, who initially brought the privatized enterprise from the state, or the immediate family of such owners. Out of 205 firms listed in the
survey, 112 firms (55 percent) are presently in operation. Following privatization, a large number of firms have closed; 83 firms (40 percent) are reported as closed. The rate of shutdown can be compared to Sahota et al (1991); they report that for every five firms in the manufacturing sector in Bangladesh, one (20 percent) shuts down. However, the definition of closure used in Sen’s survey is rather fuzzy.\(^1\) After correcting for the number of firms found engaging in alternative activity, it turns out that 55 firms (28 percent) are closed, which is higher than the rate of closure among manufacturing enterprises in Bangladesh as revealed in Sahota’s (1991) study.

10 firms (5 percent) are found to be non-existing. It can be presumed that the non-existing firms have been liquidated. Among the 112 privatized firms presently operating, the survey reports that 44 firms (40 percent) are producing different commodities than what they did prior to privatization. Among 83 “closed” firms, the survey reports 28 firms (30 percent) are engaged in alternative activities (manufacturing, trading, and services) and 65 firms (70 percent) are reported to be inactive.

In the survey, 195 firms (95 percent) provided basic information on current profitability. Without considering enterprises that have changed the type of activity, 90 firms (46 percent) are reported to be making profits or at least breaking even. When considering the enterprises that have changed their type of activity, 116 firms (60 percent) are reported to be profitable, or at least breaking even. Prior to

\(^1\) A more precise demarcation of the current status of the firm would have been as follows: (1) operational (in same business); (2) operational (in different business); (3) closed but not liquidated (incurring fixed costs); and (4) closed and liquidated.
privatization, 73 firms (38 percent) were earning profits, or at least breaking even. This shows that the number of firms making profit has increased after privatization. The survey reports that there has been substantial labor retrenchment following privatization. Cohort analysis of enterprises currently operating shows that the extent of labor retrenchment is approximately 24 percent of workers employed prior to privatization. The survey finds that the retention rate is high: Among the workers employed in privatized firms approximately 60 percent of the workers were employed prior to privatization. Among closed enterprises, retrenchment is high: Nearly 39,000 workers have been fired since privatization. The survey does not report any noticeable difference in the shedding of production and non-production workers.

**An Interpretation of the Survey Results**

Sen’s (1997) survey provides a useful set of data that sheds light on the privatization program in Bangladesh. The interpretation of the survey findings in the context of industrial organization literature on firm exit and entry, cited in the first section, is meaningful. The large number of closure and the change of the firm’s activity do not indicate a failure of the privatization drive but is an indication of the evolving nature of firms.

In the context of a country like Bangladesh, where most businesses remain closely held among family circles, the change of ownership since privatization strikes as an important change, indicating the emergence, however rudimentary, of a market for corporate control and management. Presumably new ownership can bring about new management; whereas under public ownership there is no market
for corporate governance because managers are transferred and rotated among enterprises and/or from the bureaucracy to enterprises as a function of established process of job rotation, etc.

The closure of some firms may be due to exogenous reasons. Trade liberalization has increased competition. Due to the pitiful state of the financial sector in the country, some of the new owners may have been unable to obtain working capital or re-capitalization funds from the banks. The closure or the liquidation of enterprises that are non-viable and operated solely due to continued subsidy is not always a social loss. Such enterprises should have been closed and liquidated instead of being privatized. But some firms may have closed not due to exogenous factors but because of management inefficiency.

The closure or the exit of firms, the change of firm’s activity from one sector to another sector, or the lack of continued activity in manufacturing does not necessarily imply that the privatization program has failed. One of the rationales for privatization is to subject enterprises to market forces. The closure and liquidation of firms are natural and healthy processes that eliminate inefficiencies. In developed capitalist economies, bankruptcy, involuntary and voluntary liquidation, and exit are fairly routine and frequent phenomenon that enhances the smooth reallocation of capital and labor to socially more productive endeavors. Changing demand conditions require firms to change their output mix in light of market signals. Successful firms learn to evolve in the midst of changing conditions. Under ordinary circumstances, firms engage in the “right” activities as signaled by the market as owners pursue activities that generate the highest rate of expected
returns. The ease of entry and exit supports enterprise development and generates new employment.

The good number of closure and liquidation (non-existence) of firms may suggest that enterprises are more susceptible to market conditions following privatization. Under state ownership, enterprises in Bangladesh are rarely liquidated or subject to bankruptcy. As long as firms do not face credible threat of bankruptcy and liquidation, management of firms can afford to be complacent.

Some of the firms currently closed or those that have ceased to exist can provide ingredients for the formation of new businesses. Indeed, some properties have already been converted into housing estates and storage facilities. By no means such conversion constitute an unambiguous welfare loss. For instance, the set up of storage facilities strengthens distribution and supply network. If closures of firms after privatization is not followed by entries of new firms or the expansion of existing firms and there is a general and clear trend indicating a reduction of industrial activity, then it is not a healthy development. Nevertheless, as shown in the earlier section, the exit of firms that are unable to realize profits, as tastes and technology change over time, is a routine and necessary feature of market dynamics.

At present public ownership of industry is neither necessary nor sufficient for promoting most industrial activity in Bangladesh. If the authorities believe that any particular activity is beneficial then they may attain that objective by directly subsidizing it or using some other appropriate instrument to attain their objectives rather than retain the enterprise under public ownership. However, providing direct
subsidy under a privatization regime could be politically more difficult to justify and sustain in the long run.\footnote{However one needs to qualify this claim because a substantial segment of the private sector in Bangladesh has defaulted on politically directed credit. The volume of overdue loans is substantial. The possibility of ever recovering these loans is remote.}

The reporting of the profit in the survey is voluntary. It is not inconceivable that the owners of privatized firms are reluctant to accurately report profitability in order to evade or avoid taxation. Since most of the data in the survey is self-reported, the survey results are of limited value. Further research is required to independently verify the validity of these findings.

Under public ownership the management hired an excess number of workers and often exaggerated the number of workers on its payroll. Upon privatization, the private sector is not able to support the excessive workforce and the consequent high wage bill. Thus, the large amount of labor retrenchment is not unexpected. After privatization, the new management dismisses excessive work force. The retrenchment of excess workers in these enterprises following privatization can be beneficial if it leads to a more rational reallocation of resources. The social costs of unemployment could be addressed by finding alternative employment, providing training opportunities, and giving unemployment compensation and relocation payments to those unemployed as a result of privatization.
References


