Post-privatisation changes in management control, firm activities and performance

Redda, B.M.

2 Privatisation - its theoretical arguments, objectives, outcomes and limitations in relation to the influence of contextual factors

2.1 Introduction

In chapter one, we have introduced privatisation. This chapter will deal with this concept in more detail. As already pointed out, advocates share the view that privatisation will stimulate the improvement of MCS and firm performance. In theory, privatisation is considered to lead to an efficient form of market capitalism, abolishing all failures associated with the public mode of production. However, issues such as the way in which MCS changes actually take place and whether privatisation results meet the expectations, have until now not been fully addressed in the context of LDCs. On the basis of the evidence presented in this chapter we argue, in fact, that the privatisation process may not necessarily produce the results as claimed by development economists and aid agencies. By means of case studies conducted in Eritrea, we have tried to map out the current ambiguities existing in accounting and development research. This chapter will discuss the objectives and the outcome of the process of privatisation, and the way in which external factors can actually shape MCS in LDCs.

This chapter focuses on the theoretical arguments for privatisation and its objectives (sections 2.2 and 2.3). In addition, the reasons of LDC governments to introduce privatisation programmes will be explained. Next, on the basis of evidence gathered from other studies, the results of several privatisation processes are presented (section 2.4). This evidence shows that the outcomes of these processes do not live up to the general expectations. In order to analyse the results of privatisation as described in the case studies, we will give some examples of criticism with respect to the theoretical justification of privatisation (subsection 2.4.2). Section 2.5 then describes the general issues that affect the success of privatised firms as well as the relevant contextual factors that cause MSC change in LDCs. These factors will be further discussed in Chapter 3, which will elaborate on MCS changes within firms. Our emphasis particularly lies on MCS changes and firm performance. In addition, we will consider the role of the government. The discussions in Chapters 2 and 3 will eventually lead to the development of our conceptual framework, which can be applied to the Eritrean context. The final section (section 2.6) of this chapter contains a summary of the issues discussed and the preliminary conclusions.

2.2 Privatisation and its theoretical justification

2.2.1 Definition:

In particular, politicians tend to equate privatisation with commercialisation and deregulation (Cook & Kirkpatrick, 1988, Cook Paul, 1986; Kay & Thompson, 1986). However, in economic terms privatisation remains the transfer of ownership of goods and services from the public to the private sector (Adam *et al*., 1992; Roth, 1987). In our study, we have used the definition of Adam et al. This definition formulates privatisation as the change from public ownership and/or control of enterprises to private ownership and/or control. This definition is also used by the GOE, and it is the most common one. In this definition commercialisation and liberalisation are excluded, and the following issues are included: 1) the complete or partial sale of assets by the state, 2) the transfer of assets to the private sector through leasing arrangements, and 3) the introduction of management contracting arrangements.

2.2.2 Theories of Privatisation

The advocates believe that privatisation offers the best opportunities for improving MCS and firm performance. The view that privatisation is crucial to achieving performance gains has strengthened the notion that "ownership matters" (Commander & Killick, 1988). This line of reasoning is also followed by property rights theorists. Relevant theories on the privatisation concept are: productive efficiency theories, property right theory, agency theory as well as the theory of allocative efficiency. Generally, these theories start from two types of efficiency. As they are well described in the literature, we do not intend to present an exhaustive account of them in this study. In the following paragraphs we will give an outline of the most relevant ones.

Productive efficiency focuses on a decrease in the production costs, which can be achieved by a proper management and the right incentives. In this respect, neo-classical economists argue that private ownership stimulates the implementation of efficiency-enhancing policies. Property rights are instrumental in achieving both allocative and productive efficiency with respect to the use of firm resources (Vickers & Yarrow, 1988a). It is argued that abolishing the public sector property rights has a positive impact on the productive performance and innovation of firms (Erbetta & Fraquelli, 2002). Agency theory states that agents act merely out of self-interest, and therefore incentives have to be offered that motivate them to adjust their aims to those of the enterprise. Agency theorists believe that privatisation stimulates the design of new MCS, including accounting systems (Macias, 2002). Further, privately owned firms are presumed to be governed by business goals and the capital market acts as a deterrent to managerial non-profit behaviour (Ott & Hartley, 1991).

According to Adam et al. (1992) competition generated by private ownership is essential in achieving allocative efficiency, as during this process crucial information is revealed, which is required for an efficient use of a firm's input. If the level of competition is low, it will be more difficult to detect signals on the basis of which a proper input-output balance can be determined. In addition, due to managerial inefficiency or lower levels of demand, profits may decrease. Neo-classical economists claim that the allocative efficiency of public enterprises is poor because the politicians as well as the managers and workers are motivated by goals that do not correspond with the interests of the company. They also argue that an adequate allocation of resources will be stimulated by measures such as market pricing, the removal of import restrictions or quotas, the promotion of the private sector, the curtailment of government activities by closing state enterprises, and contracting out government functions to the private sector (Toye, 1994). The view is that private rather than public ownership will produce more efficient enterprises, beneficial to consumers, the industry, and the nation as a whole (see Donald & Hutton, 1998; Flemming & Mayer, 1997; Shaoul, 1997; Ogden, 1997; Adam *et al.*, 1992; Goodman & Loveman, 1991).

Advocates consider privatisation to be intertwined with public financing and allocative efficiency. In their view privatisation reduces net budgetary transfers, eliminates possible external debt liabilities and decreases the adverse effects of deficit financing. Critics however, argue that the actual reality differs significantly from what is being claimed in most theories on privatisation. They argue that a broader range of issues (as described in sub-section 2.4.2) have to be incorporated to achieve the desired results. Generally, it is believed that improved MCS will result in both accounting practices that are more transparent and an increase in economic performance (Vickers & Yarrow, 1988b), investments, Gross Domestic Product (GDP), productivity and employment. The assumption is that these improved management control systems and accounting techniques are suitable to be introduced in any privately-owned firm. There is however, little empirical evidence to support this notion, especially with respect to LDCs (Cook and Kirkpatrick, 1995). Some studies even doubt the relevance of improved MCS in the case of LDCs. So on the basis of these findings researchers have identified some gaps in the theories on privatisation, in particular with respect to the desired outcome of the privatisation process. Although this process is believed to result in the improvement of MCS practices and firm performance, no explanation has as yet been given of how this actually takes place. We believe that this is an important issue to consider. Prior to dealing with the theory and actual practice of privatisation and the problems associated with it, we will in the following section go into the motives behind privatisation, especially from the perspective of LDCs.

2.3 Privatisation: the objectives and its necessity for Developing Countries

The privatisation concept forms the core of the market-based alternative to public management, and plays a crucial role in most of the structural adjustment programmes implemented in LDCs. That is why many consider the introduction of private ownership as the cornerstone of a successful transformation of the LDCs' economies (Rider, 1994). A common view is that the privatisation process in developing countries is being stimulated by both internal politics and external pressures (Adam *et al.*, 1992; Ramanadhan, 1989, Hemming & Mansoor, 1988, Cook, 1986). Studies show that the external pressures mainly come from the developed countries, the IMF and the World Bank. They stimulate LDCs to introduce policy reforms. In addition, developed countries offer them development packages with a clear focus on market-oriented approaches and less government involvement. In some cases, the awareness of the need for change has emerged within the LDC governments themselves (Cook, 1986; cited in Uddin, 1997). The World Bank is unequivocal in its support for privatisation: "Privatisation, when correctly conceived and implemented, fosters efficiency, encourages investment [and thus new growth and employment], and frees public resources for investment in infrastructure and social programs" (Kikeri *et al*., 1992). All privatisation methods aim at generating revenue and stimulating corporate control as well as competitiveness. Most research, therefore, focuses on the improvement of the efficiency of enterprises (Vickers and Yarrow, 1991). State-owned enterprises can generally be characterised by inefficiency, mainly caused by overstaffing, a dependence on subsidies and the absence of competition (Lieberman, 1993). Studies indicate that cost savings are the most important source of performance improvement (Fahy & Smithee, 1999).

Research has also shown that in terms of profitability and added value the performance of public enterprises is poor compared to that of firms in the private sector (Ayub & Hegstad, 1986; Killick, 1983; Kim, 1981). Public enterprises do not seem to be capable of generating sustainable returns from investments, which generally leads to budgetary difficulties (IMF, 1986; Short, 1984; World Bank, 1983, 1981). Evidence indicates that the poor performance of public enterprises is due to political interference in their decision-making processes, and their own incapability to set specific goals and develop incentive schemes (Milward *et al.*, 1982). In this context MCS become irrelevant, as the political influence on the enterprise's decisions undermines its commercial inventiveness and accountability (Jones & Sefiane, 1992).

In general, privatisation is considered as an obvious solution to the problems of the public sector (Shirley & Walsh, 2001). Market mechanisms are believed to improve efficiency and resolve public finance difficulties (Cook & Kirkpatrick, 1988). The advocates of the privatisation principle argue that the transfer of property rights to private hands and the resulting competition will stimulate the improvement of MCS and the development of business goals (Rees, 1985: cited in Wickramasinghe *et al.*, 2004). So when it comes to solving control problems, ownership does matter, as is the general belief. Moreover, it is claimed that management control systems help businesses to set and achieve their objectives, such as for example profit maximisation (Jensen & Meckling, 1976). In a privatised economy these "micro level profits" will then result in "macro level (capitalist) development" (Tinker *et al*, 1982). Through this "profits" mechanism the production means will be employed more "efficiently and effectively" (Rees, 1985). So, ownership change increases "profits", thereby facilitating a country's "economic development".

In actual fact however, the motives for privatisation vary among countries. In the case of LDCs, for example, privatisation is influenced by the macroeconomic burden of the public sector. The legacy of state ownerships consists of fiscal imbalances, unused social services funds, and extensive private sector borrowings, which by the 1970s accounted for one-third of the LDCs' international loans (*ibid*). Evidence shows that financial flows to public enterprises burden government budgets and the financial systems in sub-Saharan Africa considerably (World Bank, 1994). For this and other reasons, the World Bank started to encourage the introduction of privatisation programmes as a means to decrease the weight of the Public Sector on the fiscal budget, and as from the mid 1980s it used them as a condition for the provision of loans. From this period on, privatisation measures in LDCs have considerably increased (Cook & Kirkpatrick, 1988).

The main motive of the governments of LDCs for starting the process of privatisation is to gain economic benefits. The objective is to generate additional state revenue, promote economic efficiency while at the same time maintaining the level of employment and reducing the involvement of the government in the management of enterprises. Other objectives are the transfer of ownership to the private sector, introducing competition through economic liberalisation, exposing public enterprises to market discipline, developing capital markets and attracting national and foreign investors (Megginson *et al.*, 1994). By achieving these goals government money, otherwise spent on subsidies, will be saved and political and social stability will be achieved through a more balanced allocation of resources. Moreover, there will be more economic growth and new opportunities will be created with respect to employment. The general expectation is a higher output, increasing investment levels, a supply of quality goods and services at low prices, a growing use of modern technology and know-how, higher profits and dividends, more employment and higher salaries, a reduction in leverage, effective corporate governance, financial benefits and a decrease in taxation levels (Makalou, 1999). In addition, LDCs aim at obtaining a maximum output from scarce resources and reducing poverty. In brief, their main focus is on economic development (Parker & Kirkpatrick, 2005). However, Kikeri (1998) points at the circumstance where as a result of the privatisation process prices increase and employment as well as tax payments decrease. In that case poverty will only be aggravated. In addition, governments also need to pay attention to trade union reactions to job losses (Young, 1995).

Only a relatively small number of LDCs have privatised their economies, and not until the late 1980s (Cook & Kirkpatrick, 1988). Many governments of LDCs have restricted themselves to reforms within the public sector to improve the efficiency of state-owned enterprises (Cook & Kirkpatrick, 1995). However, the results of these reforms have been disappointing. Sub-Saharan African countries mainly focus on improving the accountability practices in the public sector to gain growth in GDP. Also, donors believe that the improvement of accountability and transparency will reduce the level of corruption and mismanagement (Okeahialam & Kedslie, 1999). Because the public sector reforms did not work and the sub-Saharan states were in fact dependent upon aid agencies, they were finally encouraged to start privatising. Makalou (1999) indicates that the number of privatisation transaction has increased from less than 200 in 1990 to over 2,800 by the end of 1997.

De Castro and Uhlenbruck (1997) point out that the privatisation policies and firm strategies in LDCs are significantly determined by the specific characteristics of these countries. In the West there are mature capital markets, venture capitalists, banks and other kinds of loan creditors, a well-functioning legal system that protects private property rights, and conventional standards of business conduct that facilitate the exchange of products. LDCs are lacking these institutions. The shortage of administrative and institutional capacity has hindered the development of competition policies and the establishment of regulatory agencies to prevent market abuse (Parker & Kirkpatrick, 2005). The market conditions in LDCs are not good enough to ensure proper functioning of the private sector. Moreover, in some LDCs there is no mechanism to protect private property rights, which discourage organizations to make investments due to the threat of expropriation. In addition, because of the absence of well-developed markets, only certain groups (those with high incomes or families who can count on government backing) are in the position to make investments (Saha & Parker, 2002). Moreover, local entrepreneurs who have purchased public enterprises may not possess the necessary working capital and management know-how required to make their businesses a success.

Although the public sector in Africa has actually succeeded in providing resources and welfare functions, the economies of a large number of countries are in a deplorable state, which is reflected by huge debts and a large dependency on government subsidies. Companies are characterised by excessive manpower, bureaucratic control, undercapitalisation, and a shortage of qualified managerial and technical personnel. Their monopoly position has increased inefficiency and undermined firm performance. That is why the divestiture programmes in Africa were especially aimed at those enterprises that made losses and were financially unhealthy, heavily indebted, operating with inadequate records or accounts, or substantially overmanned.

Several studies indicate that privatised enterprises in LDCs are performing well and contribute to the overall economic prosperity (Galal *et al.*, 1994; Megginson *et al.*, 1994: cited in Cook & Uchida, 2004). Primarily, a healthy private sector is a crucial condition for establishing a sound economy. In a free market where there is a relatively open access to inputs, where enterprises can autonomously make decisions with respect to investments and operational strategies, and where there are fair incentives that apply to all participants, private enterprises can generate productivity growth (Khatkhate, 1992) and large economic returns.

According to the literature LDCs mainly view the concept of privatisation as the transfer of products or services from public to private ownership and control. In the case of Africa, it was not until the early 1980s when privatisation was first considered as a serious economic alternative, and initially the focus was mainly on public sector reform and economic liberalisation (Young, 1995). A World Bank study (Berg & Shirley, 1987: cited in Young, 1995, p. 163) shows that although by the mid 1980s there were 26 LDCs (14 of which were African states) that put privatisation on their public agendas, only 17 have actually carried out equity transfers. In addition, African states accounted for 35 percent of the 1,343 world-wide privatisations (planned, in the process or completed) recorded by the World Bank in 1988. This means that only 10 per cent of Africa's public enterprises have been privatised (Young, 1995). That is why in our view it is vital to conduct privatisation studies in the context of LDCs. This research should focus on both the achievements (with respect to MCS changes and firm performance) and the problems. Moreover, it should consider the implications for privatisation theory in general and the economic policies of LDCs in particular.

2.4 Outcomes of Privatisation

There are serious doubts whether privatisation has actually produced the results as claimed by its advocates and theorists. Despite some positive achievements, researchers have identified a number of theoretical problems that are supported by empirical evidence. The following sub-sections will deal with the empirical evidences and also the theoretical problems of privatisation.

2.4.1 Empirical evidence gathered from privatisation studies

Since the 1980s, privatisation has been the most significant approach in global market reform. In general, privatisation is associated with economic liberalisation, free trade, competition and limited government intervention. In spite of the fact that it was introduced decades ago, there is not much documentation available about privatised firms, which is considered as a major concern (Adam *et al.*, 1992; Cook & Kirkpatrick, 1988). Only after a considerable time after their global introduction have researchers started to investigate the results and effects of privatisation programmes. Several studies on post-privatisation effects have been published (Cook, 1986; Cook & Kirkpatrick, 1995; Megginson & Netter, 2001; Parker & Kirkpatrick, 2005), but their findings are somewhat ambiguous and contradictory. Comparative studies were, for example, conducted by Weiss (1995) to evaluate the performance of state-owned and privately-owned corporations, and by Karatas (1995) to compare the performance of enterprises during the pre-privatisation and the post-privatisation periods. These studies have not provided significant and conclusive data. In addition, the empirical evidence presented in the development literature does not offer significant clues to the nature of the internal changes taking place within firms during the privatisation process (Wickramasinghe, 1996). Before going into the details of the findings resulting from research conducted mainly in LDCs, we will give a general outline of privatisation studies carried out in both the West and in developing countries.

Studies conducted in the West: The empirical evidence collected so far on the effects of privatisation in developed countries is inconclusive. Wright *et al.* (1993) show that in several cases privatisation has had a positive impact on firm performance through so-called management buy-out practices. On the other hand, other studies indicate that privatisation policies have resulted in the transfer of a large amount of public wealth into private hands. For example, a study by Shaoul (1997) on the privatisation of the provision of water shows that contrary to the government’s expectations, no efficiency gains were achieved, a percentage of workers actually lost their jobs, consumer prices rose, and the infrastructure deteriorated. In a study conducted in 1999, Arnold & Cooper (1999) report that the UK government only received £ 13,1 million for the sale of a port, which was resold 18 months later for £ 103,7 million. Those who mainly benefited from this undertaking were the managing directors and the banks that financed the buy-out.

Studies conducted in LDCs: The results of the empirical research into the effects of privatisation in LDCs are also inconclusive (Cook and Kirkpatrick, 1995). Some studies show that the profitability of public enterprises is lower than that of their private sector counterparts in the same industry (Ayub & Hegstod, 1986; Killick, 1983; Kim, 1981; Funkhouser & MacAvoy, 1979). Other studies, however, indicate that the efficiency levels of public sector enterprises are in fact higher than those of private sector corporations (Ramaswamy, 1988; Wortzel & Wortzel, 1989). Potts (1995) conducted research into denationalisation and production efficiency in Tanzania. In two states the management of organisations had improved after privatisation, whereas in others it had declined. According to Potts there is a relationship between management decline and production performance. Further, Potts concludes that apart from some macro-economic benefits, a clear disadvantage of the privatisation process is the transfer of ownership to foreign-based companies. When using size, market structure, industry trends and ownership as variables to investigate possible changes in performance, Weiss (1995) found no significant evidence for the assumption that public enterprises perform less good than private companies. Moreover, he has found no proof that privatisation measures increase economic efficiency. What Weiss’ study does show us is that in particular branches, foreign-owned firms outperform national firms. Karatas (1995) compared pre- and post-privatisation firm performance in Turkey by using financial measures as point of departure. No significant differences were found.

Although the theory suggests that privatisation leads to the improvement of MCS practices, researchers generally show little interest in finding empirical evidence that supports this assumption. The available evidence does not convincingly show clear improvements in the performance of enterprises as a result of privatisation. In Sri Lanka (Wickramasinghe, 1996) privatisation did not lead to higher levels of profitability or productivity, and after privatisation in Mexico, consumers did not benefit at all (Martin, 1995). In addition, a study by Uddin and Hopper (2003), conducted in 13 privatised firms, shows that returns did not increase; in fact, states revenues as well as employment decreased. In addition, transparency in external reports was not achieved, and some shareholders, creditors and tax collecting institutions were affected by wrongful transactions.

Asechemie (1997) argues that concepts such as owner profit or wages are irrelevant in Nigerian society, particularly in the informal sector. Wickramasinghe and Hopper (2005) claim that Western MCS techniques are not suitable for Sri Lanka's local culture. This problem is also pointed out by Perera (1989); he indicates that accounting practices in their current form are not suited for LDCs because of the differences in business environments, ownership structures, use of accounting information and attitudes towards disclosure practices, which stem from the colonial era. Therefore, some degree of reserve with respect to the assumptions of the advocates of privatisation is justified (Burchell *et al.*, 1980). It can be concluded that the adoption of Western MCS techniques by LDCs leads to problems because of the different socio-economic, cultural and political circumstances (Hopper *et al*., 2004b; Wickramasinghe, 1996). Issues such as culture (Velayutham & Perera, 1996) and ethnic conflicts, as in Ghana (Tsamenyi, 1997), play an important role in the development of MCS. However, in some countries, for example Syria (Abdeen, 1980) and China (Chan & Lee, 1997: cited in Hopper *et al.*, 2004b), Western MCS techniques can sometimes be applied successfully.

Hopper *et al.* (2004a) have found evidence that in some cases the introduction of computerised systems by privatised firms has improved the link between production and market information. However, the transparency in the internal and external information flows, which is an essential element of market control, is still insufficient due to the weak regulations and their inadequate enforcement. In addition, case studies conducted in Bangladesh and Sri Lanka (ibid) show that MCS practices are being hampered by the inexperience of firm owners and top management. In general, it can be claimed that external factors, such as aid agencies and the state (Hoque & Hopper, 1994), play an important role in shaping the nature of MCS practices. Also other external factors, such as political climate, industrial relations, competition and government regulations, influence the development of MCS, as is illustrated by a study on the privatised jute mills in Bangladesh (Hoque & Hopper, 1997).

In Bangladesh annual reports were not produced, and the families who owned the firms were in charge of the company finances. Budgeting policies were conducted top down, and the labour force was subjected to inferior conditions, having little union protection.

In Sri Lanka, after the privatisation process had been completed, the textile mill managers continued to keep the budgets low to maintain the ethnic divisions and to protect the local workers. There was evidence of financial malpractice. The partial privatisation did not reduce the interference of the government; it was only less direct through the intermediation activities of regulatory agencies (Hopper *et al.*, 2004a).

Also Perera (1975) argues that Sri Lankan firms are more interested in preparing tax return than in drawing up accounting reports. Overall, the lack of transparency and accountability is mainly caused by factors such as weak capital markets, accounting regulations that are not carried out properly, a culture of tax avoidance, and inappropriate education in the field of accounting.

The study of Al-Rohaily (1992) on the MCS in 25 large Saudi enterprises shows that MCS techniques are often inadequately applied for planning and control purposes, and in some cases they are not used at all. This was due to a lack of internal control, inefficient costing systems, and a shortage in accounting staff. Also Mustafa (1985) affirms that with respect to external as well as internal requirements the transfer of accounting information of Saudi firms is deficient. This is mainly because their management control systems are not well-structured; there are no proper forms, procedures and records, and internal control instruments are seriously inadequate or do sometimes not even exist.
Al-Namri (1993) examined the similarities and differences between the MCS practices of Saudi-owned and -managed enterprises and those of Western joint ventures operating in the country. Al-Namri concludes the MCS techniques as applied by joint venture firms are generally more elaborate and sophisticated than those used by Saudi-owned enterprises.

Over time, the accounting literature has been influenced by the developments linked to ownership as well as control changes, such as privatisation, management buy-outs (MBOs) and take-overs. According to Jones (1985) the use of management control systems was helpful in the decision-making process during the transition period prior to mergers, but after the change of ownership their role decreased considerably. The modification of old systems has also led to the development of new MCS, resulting from a change in management style aimed at the delegation of authority and clearer regulations. Wright *et al.* (1993) provide examples that illustrate positive effects of privatisation. In their study they show that buy-outs lead to performance improvements both in the short and in the medium term. In their view ownership change and improvements in management and MCS practices have resulted in a well-structured transfer of financial information, the introduction of employment contracts, possibilities for negotiation, and the abolishment of subsidiaries' investment constraints.

Critical studies: Jomo (1995) has studied the post-privatisation effects in Malaysia. Advocates in Malaysia share the view that privatisation has had a positive effect on government finances, economic growth, efficiency and the distribution of wealth. Jomo argues that these claims are vague and even incorrect. His study indicates that there is no clear evidence that supports the notion that privatisation has significantly contributed to the recent economic growth. He argues that the privatisation trajectory in Malaysia consists of "Bumiputera (indigenous) wealth acquisition"[7] programmes, the objectives of which are in contrast with the privatisation principle. Uddin and Hopper (2003) have analysed a report by the World Bank on the post-privatisation performance of several companies in Bangladesh. They question both the conclusions of the World Bank's assessment and its claim that privatisation has a positive effect on the MCS practices of enterprises and their performance and development.

[7] "Bumiputera wealth acquisition" means that the privatisation process in Malaysia has merely aimed at enhancing the wealth of the Malays and native people of Malaysia, and that private ownership by foreign entrepreneurs was not allowed (see Uddin, 1997; Jomo, 1995).

Studies on family-owned businesses: Family ownership is a common phenomenon in post-colonial countries. In family-owned enterprises, the family are both the owners and managers, and control practices are highly centralised and to some extent arbitrary. This means that personal relationships are more important than formalised rules and regulations, and no use is being made of formal control instruments (Black *et al.*, 2000). In addition, the cultural values in Eastern countries are different from those in the West. In Eastern societies the focus is clearly on the collective rather than on the individual perspective. In the decision-making process family and friends are central and formal rules and regulations play a minor role. Family ties and informal relations also influence decision-making in general. Similar findings have been reported by Uddin (1997), Wickramasinghe (1996) and Hoque & Hopper (1994).

In general, private ownership stimulates a commercially-oriented approach, which is reflected, among other things, in the control instruments. The use of computers has led to more efficient production process and marketing activities. Work targets have become tighter with effective monitoring. Private owners instituted ad hoc and arbitrary (informal) controls over employees. The control systems hardly relied on proper incentives and transparent budgetary controls (Hopper *et al.*, 2004b).

Ansari and Bell (1991) conducted a longitudinal case study in which a Pakistani family-owned firm was being observed in the period from 1967 to 1989. The study dealt with a broad range of control issues, such as the organization's formal structures and operational controls, its reward, planning and budgeting procedures. Ansari and Bell established that the firm's policies and business strategies were mainly based on the cultural background and beliefs of the organizational members. There were no shareholding agreements, the emphasis was on the needs of the employees rather than on performance, and family hierarchy played a major role, which was reflected, for example, in the way staff members were appointed. In addition, there was no separation between treasury and control functions, and rewards were not distributed equally and fairly. The authors therefore argue that cultural values and family relations have a significant influence on controls. Other studies show that the efforts of Third World countries to develop economically are undermined by their inadequate accounting techniques (e.g. Enthoven, 1969; Scott, 1968; Hunter, 1964; Bevis, 1958).

In-depth studies: The studies of Ogden (1994)[8], Wickramasinghe (1996) and Uddin (1997) address privatisation issues from a socio-political perspective. The study of Wickramasinghe is an assessment of privatisation in the context of LDCs. Its starting point is the Mode of Production (MOP) theory, which is applied to compare the MCS practices in both capitalist and

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[8] This study deals with newly privatised water companies in the UK and focuses on management decisions and firm performance. The study explains the role of MCS in the attempt to translate a political objective into a business strategy aimed at meeting consumer needs.

non-capitalist settings. Wickramasinghe argues that in non-capitalist settings the nature of MCS is influenced by state policies and ineffective bureaucratic rules. After the process of ownership change, the accounting practices were modified, being no longer subjected to non-capitalist elements. Still, in LDCs cultural beliefs have a large impact on privatised businesses in general and MCS and accounting practices in particular. The economic theories do not take this into account. Wickramasinghe shows this limitation in a study on the MCS changes in a privatised Sri Lankan Textile mill. In Sri Lanka tradition and culture are still heavily embedded in society, and also the post colonial politics play a dominant role in its corporate world. Wickramasinghe argues that accounting researchers and policy-makers do not pay enough attention to the cultural beliefs and labour mentality in developing countries.

It can be concluded that with the exception of Uddin (1997) and Wickramasinghe (1996), the current accounting studies fail to address privatisation issues more deeply from the perspective of LDCs. Although the studies of Ogden (1993) and Armstrong (1991) provide more insight into ownership change and MCS in developing countries, very little is known about the adjustment of MCS in these countries, in particular as a result of privatisation (Uddin, 1997). The examples given above show that in the case of LDCs, attaining the objectives of privatisation and improving MCS practices and firm performance is complicated by a range of contextual factors. These factors will be further elaborated in section 2.5 and in Chapter 3.

2.4.2 Theoretical problems of privatisation

As we already have pointed out, the privatisation of businesses in Western economies has not always led to a decrease in prices, higher efficiency and better services. Firm performance is in fact influenced by a large number of factors. For example, the efficiency of privatised enterprises is not only dependent on ownership, but also on the degree of competition, incentives, and the effectiveness of regulatory policies (Yarrow, 1986). Similarly, the improvement of firm performance requires much more than just a change in ownership resulting from privatisation (Chang & Singh, 1992: cited in Cook & Kirkpatrick, 1995). It is also related to organizational issues, institution-building and politics. Firm performance should be considered in the wider context of socio-economic factors and political reform aimed at improving the general standard of living and welfare (Cook & Kirkpatrick, 1995).

The following sections will focus on the viewpoints of those who are critical towards the current theories on privatisation. Although the privatisation process is vital to improve the economy and stimulate firm performance in LDCs, the Western approach is not always the most suitable one. There are a large number of specific factors that influence the outcome of the privatisation process in developing countries. These will be dealt with in section 2.5. It is argued that in the case of LDCs, privatisation issue should be approached from a broader perspective. Moreover, the current theories do not fully explain how organizational change processes actually take place. Below a summary is given of the main points of criticism with respect to the various theories.

Production Efficiency Theories: Principal-Agent relationships may be common in small firms, but in the large modern limited liability corporation the property rights are diluted. Diluted ownership reduces the control of owners over managers. As a result, managers have a considerable amount of freedom to back their own interests (Commander & Killick, 1988; Adam *et al*., 1992). Moreover, the implications of ownership with respect to production and efficiency depend to a high degree on the nature of the business environment. These environmental factors have a considerably larger impact on firm performance than ownership. Therefore, apart from ownership, these factors, including competition and regulation, have to be taken into account when assessing the privatisation process (Van Brabant, 1995).

Agency Theory: Critics argue that the empirical validity of the views on which this theory is based is dubious. Full information is hard to obtain in practice and thus information processing is highly complex. Moreover, internal conflicts undermine communication between organizational members. In addition, in LDCs the competitive markets are still poorly organised, and the economic relationships and motivations are much more complex than is being portrayed by the agency theory. It is difficult to model them by means of this theory. For example, trust is not dealt with (Armstrong, 1991; Neu, 1991). Further, the relation between a manager's efforts and the output in terms of profitability is more difficult to determine than is being suggested in this theory.

Allocative Efficiency: Critics argue that allocative efficiency also applies to public enterprises. Deregulation, liberalisation and competition are important conditions for the success of privatisation programmes, but not essential (Jackson and Palmer, 1988). In addition, the fiscal effects of privatisation are overrated, especially the reduction in budget deficits through the elimination of financial subsidies (Adam *et al*., 1992). Subsidies are the result of budget policies (Ramaswamy, 1988), and they may continue after privatisation, for example, price support for farmers.

Property rights: Property rights that are poorly defined, insufficient protection against theft and expropriation, breach of contract, these are all factors that undermine efficiency (Bocko, Shleifer and Vishny, 1995). Barzel (1989) points out that property rights are never entirely accounted for by the law, and that issues such as expropriation, free-riding, and eluding the law are quite common. In addition, Starr (1988)[9] argues that the property rights school fails to recognise that the separation of ownership and management alters the nature and functioning of private firms. Further, property rights theory rules out the significance of aspects such as size, centralisation,

[9] Available at: http://www.princeton.edu/~starr/meaning.html or Paul Starr, "The meaning of Privatization", Yale Law and Policy Review 6 (1988): 6 – 41.

hierarchy, or leadership. Finally, it does not recognise the relationship between firm performance and the exchange of information or ambiguity about business goals.

The general view of critics is that privatisation is not the answer to public sector problems. Wortzel and Wortzel (1989) argue that public enterprises do not perform that poorly at all. And there are many public enterprises that actually perform quite well, for example, those in Brazil and Korea. There are researchers who believe that the success of an enterprise depends on good management rather than on ownership. Important measures in this respect are creating a stimulating organizational culture (Schwartz & Davis, 1981), appointing good managers (Vernon, 1984), designing effective control systems (Ramamurti, 1987) and formulating attractive incentive schemes (Aharoni, 1981). These are crucial to achieving organizational success.

Studies on ownership transfer show that privatisation alone is no guarantee for an increase in productivity and a reduction in costs. Other important factors are effective competition, regulation, and organizational or political changes (Parker & Kirkpatrick, 2005; Megginson & Netter, 2001). Research conducted in particular industrial sectors and firms shows that although privatisation has a positive impact on productivity, production efficiency, prices and service delivery, it is not solely sufficient to raise economic performance (Parker & Kirkpatrick, 2005).

In order to ensure the improvement of economic performance, privatisation has to be introduced together with other measures of structural reform (Parker & Kirkpatrick, 2005). Moreover, the privatisation concept is based on theories (property rights theory, agency theory, productive efficiency theories, and allocative efficiency theories) that focus on, among other things, effective corporate governance reflected in particular behavioural patterns of management, for example, discreteness and an open exchange of information. This type of behaviour is often not associated with state officials. That is why these theories are less applicable in LDCs that lack effective corporate governance. Privatisation programmes can only be successful in LDCs when integrated with a broader development agenda (Parker & Kirkpatrick, 2005).

2.5 Factors that affect the success of privatised firms and MCS change in LDCs

In the previous sections we have briefly assessed the practical and theoretical problems of privatisation. In this section we will first introduce the major - however frequently neglected – issues that have a large influence on the development and performance of the private sector in LDCs. Next, we will deal with the relevant external contextual factors that determine the MCS practices after the enterprises have been privatised.

2.5.1 General factors that affect the success of privatised firms

Factors that critically affect the development and success of the private sector include monopolies of state enterprises and bureaucratic rules and impediments, for example price controls, the lack of choice of geographic locations, and restrictive labour policies with respect to wage negotiation, productivity bargaining and the position of unproductive workers. Also factors such as requirements for the use of local supplies, ambiguity of the legal and policy framework, slow and arbitrary decision-making, and a large number of institutions that are corrupt seriously impede a favourable business environment. Moreover, if there is a limited access to resources and support services, such as financial information and stock markets, it will be more difficult for firms to operate successfully. Other factors that affect the functioning of privatised firms are foreign trade regulations and exchange controls, excessive government borrowing, heavy taxation, socio-political instability and monopolisation through public investment programmes (UNIDO, 1999)[10].

The UNDP Report (1998)[11] mentions two conditions crucial for the success of privatisation. First, firms should operate in a *competitive* or *open market*. Second, the *macroeconomic circumstances* and *policy frameworks* should be 'market-friendly'. Similarly, Kikeri *et al*., (1994) refer to these conditions as market and country conditions respectively. In this respect, Chisari *et al.* (1997) argues that privatisation in itself will not be successful if there is no macroeconomic stability, liberalisation and deregulation. Therefore, a precondition for privatisation in LDCs is to create a 'suitable environment', in which the private sector can effectively operate. In the case of Africa, the weakness of the private sector is the result of problems such as inconsistent macroeconomic policies, the lack of physical infrastructure and underdeveloped financial systems (Kennedy & Hobohm, 1999). In addition, the dominance of the state in the past has left its mark on today's institutions. One aspect that hampers *private sector development*[12] in Africa is the fact that there is a large fragmentation of small-scale economies. As a result, Africa's status in the world trade is marginal. Further, there is a continuous political instability. Also Brunetti *et al.* (1997) emphasise that the institutional obstacles are undermining a healthy business climate in LDCs.

In the majority of LDCs the condition of roads, ports and airports is poor. This also applies to the access to water, power supply and communication facilities (World Bank, 1994). In addition, on the macroeconomic level price volatility is a severe problem. In Latin America and sub-

[10] The UNIDO conference on 'Industrial Partnerships and Investment in Africa' (20-21 October, 1999) held in Dakar (Senegal) addressed ways of strengthening the capacity of private sector institutions in Africa. It stressed that although governments play an important role in supporting the private sector, services should be provided indirectly.

[11] Part 2: State and Market roles in Governance http://magnet.undp.org/Docs/!UN98-21.PDF/!PSMGSHD/!sec2.pdf.

[12] "The climate for private sector development in Africa", by the International Finance Corporation, 2003: http//www.altassets.com/pdfs/AfricaIFC.pdf.

Saharan Africa the volatility level of prices has always been the highest, but in fact all developing countries have performed badly compared to the West (Hausmann & Gavin, 1996; World Bank, 1993). Therefore, these issues have to be taken into account in the privatisation process of firms in LDCs. Moreover, what the private sector requires is innovative entrepreneurs, skilled managers, a dedicated and well-trained labour force, and efficient administrative and operational procedures. Further, governments are responsible for creating a suitable business environment in which privatised firms can prosper and increase their performance.

2.5.2 External contextual factors that shape MCS change in LDCs:

As already mentioned, the results of privatisation in LDCs are influenced by various contextual factors. In the remainder of this chapter these factors and their influence on MCS practices will be discussed. Hopper *et al.* (2004a) argue that accounting practices are typically Western-based, representing Western systems and values. If the proper environment is created, MCS can also effectively be applied in LDCs (Little, 1982). This is difficult however, due to the socio-economic legacy of the state-owned enterprises, ineffective institutions and, of course, the cultural differences (Nabli & Nugent, 1989). As a result, the capital markets are underdeveloped. Introducing MCS in LDCs is therefore rather complicated, and in order to make its implementation a success, a number of contextual factors have to be taken into account (Neimark & Tinker, 1986; Bauer & Yamey, 1957).

So the way in which management control systems are modified as a result of the privatisation process is influenced by the historical, social and political dimensions of the economy in which the organizations are embedded (e.g., Broadbent, 1999; Hoque & Alam, 1999; Hoque & Hopper, 1997, 1994; Scapens & Roberts, 1993; Broadbent & Guthrie, 1992; Innes & Mitchell, 1990). Therefore, in order to gain more insight into the exact nature of MCS change in LDCs, we will identify and assess these contextual factors (Scapens & Roberts, 1993; Luft, 1997). We will discuss such factors in relation to the concept of “market capitalism” as defined by Hopper *et al.* (2004a). Market capitalism fits well with the economic policy of the GOE.

The structural adjustment programmes of the World Bank and the IMF are based on the market capitalism principle, a neo-classical approach aimed at free trade, competition, privatisation and limited government intervention. Institutional reform is generally focussed on marked-based prices, which means that markets have to be restructured (financial markets, agricultural markets, commodity markets). Quantitative restrictions have to be removed and entrepreneurial activities promoted. In addition, government involvement has to be restricted by taking over or closing public enterprises and contracting out government functions to private sector competitive bodies (Toye, 1994: cited in Hopper *et al.*, 2004a). The contextual factors that influence the MCS practices of privatised firms include culture, race and ethnicity, the state and regulations, trade unions, aid agencies and market competition. We have also included war as an important contextual factor. War has had an enormous impact on the economic situation and the performance of Eritrean firms.

Culture, Race and Ethnicity: In the implementation of privatisation programmes in LDCs no particular attention is being paid to cultural issues. It is believed that modern capitalist beliefs, attitudes and customs either already exist or will spontaneously emerge during the process of privatisation. Workers are expected to adjust easily to the modern MCS practices, economic rewards, and labour contracts. The general assumption is that by introducing Western technologies and organizational structures workers will instantly conform to the economic individualism and individual responsibility associated with capitalism. They are expected to be familiar with concepts such as quality consciousness and continuous improvement. Moreover, social homogeneity would emerge in the workplace, which means that differences between ethnic and racial groups will become irrelevant as a result of the Western economic reward systems and private sector management methods based on the meritocracy principle. Performance measures as well as budget and compensation instruments help set the managers' (or agents') expectations. A loose budget or generous compensation may motivate an agent, but also create certain expectations that the opposite party will not be able to meet in a later stage (Hopper *et al.*, 2004a).

State and Regulation: Hopper *et al.* (2004a) argue that in LDCs the state has a great influence on the development of MCS. In LDCs the state plays a central role in the economy in the absence of a capitalist class that operates in Western countries. The state is the provider of capital and employment and it controls a large proportion of the GDP. Although the state plays a leading role in the process of modernisation, it is restricted by non-capitalist cultural factors, such as relations and ties based on family, village, caste, religion, region or ethnicity. So in the case of LDCs neutral instruments of regulation used in enterprises may become instruments of power for illicit and non-capitalist purposes. Accounting is not immune from this: as a result of the aforementioned cultural factors, the function of accounting systems as regards planning, control and accountability may be undermined.

The introduction of privatisation within structural adjustment programmes paved a way to counteract political interference into the management of enterprises. The belief is that private ownership will introduce more effective controls and use measures of the capital market to modify the deficiencies of the state-governed economy. However, because of the fact that in LDCs the concept of capitalism has no historical basis, these countries may respond differently to the sudden introduction of privatisation programmes (Hopper *et al.*, 2004a). Moreover, in LDCs government policies usually still play a significant role after the privatisation of firms. These factors affect the business strategies adopted by firm owners (Macias, 2002), and may undermine the effectiveness of the instruments of capitalist mode of production such as MCS. A country's political and institutional situation affects economic performance (de Haan &

Simermann, 1996) and has a significant influence on property rights and private investment (Feng, 2001). In the case of LDCs, politics hampers post-privatisation regulation and competition.

From the perspective of privatisation, the state's role should remain confined to supply-side economics, safeguarding the infrastructures, maintaining law and order, and correcting market distortions (Corden, 1974). The focus should be on providing an environment suitable for commercial mobility rather than on direct interventions into enterprise decisions. Regulatory structures facilitate market relations (Hopper *et al.*, 2004a). However, in LDCs the role of the government is generally harmful (Campbell, 1993; Lal, 1983; Bauer, 1976), as its intervention creates enormous price distortions and inefficiency of the market. The degree of economic power of the state is considerably higher in these countries (Wickramasinghe, 1996). Moreover, government incentives are highly unequal in that some economic actors are given more privileges than others, which only decrease economic performance (Little *et al.*, 1970). In order to achieve a successful implementation of the privatisation concept in LDCs, the role of the government should therefore be limited. In addition, it is the task of the government to facilitate provision of skilled labour force, finance, and an adequate infrastructure during the transition phase to privatisation.

Trade Unions (**TU**): TUs represent the collective labour force on the basis of rules and regulations. Their function is that of arbitrator as well as protector of the rights of the individual workers. They monitor law enforcement with respect to misconduct in the area of contractual obligations (Burawoy, 1979; Weinstein, 1968; Selznick, 1969; Habermas, 1975: cited in Hopper *et al.*, 2004a). The 'internal state'[13] mediates in shop floor conflicts through negotiation in a framework of collective bargaining (Reuther, 1958). The aim is to achieve common goals on the part of both the union and the companies in terms of entrepreneurial growth and survival (Przeworski, 1978). In LDCs the political power of trade unions is substantial, both on the local and on the national level (Hopper *et al.*, 2004a). Globally, TUs are the strongest opponents of privatisation, since they are given substantial benefits by government-owned firms in exchange for political support (Lopez-de-Silanes 1997, Lopez-de-Silanes *et al.* 1997).

In the context of market capitalism, TUs are expected to collaborate with the privatised enterprises within the structures of collective bargaining. Their role is that of mediator between the work floor and management (Tsamenyi & Hopper, 2003). Links to parties and politics should be abolished. Labour markets start from the market-based reward principle with the aim to stimulate the mobility of workers. Recruitment should therefore be based on employee training and qualifications. The task of the government is to establish education and training institutions, while focussing on the development of skills and 'technical' work, and promoting

[13] The 'internal state' consists of a number of institutions that mediate in conflicts on the enterprise level (Hopper *et al.*, 2004a).

social values consistent with a market economy (c.f. Hopper *et al.*, 2004a). In capitalist societies the economy is dominated by labour markets. However, LDCs have no labour market tradition and thus the legal position of employees is vulnerable.

Aid Agencies [International Finance]: Many LDCs are suffering from factors such as poverty, fiscal crises of the state, bad governance and natural disasters. Moreover, their domestic markets are weak. As a result, LDCs are dependent on capital from multinationals with business locations in these regions as well as on loans and grants from international aid agencies, foreign governments and international financial institutions (such as the World Bank and the IMF). This dependency has facilitated the transfer of Western accounting technology to these countries. The World Bank and the IMF stimulate LDCs to adopt a neo-classical approach in their economic development. These institutions expect the LDCs to follow their advice in policy adoptions and restructuring of their economic and social structures.

Especially because of the concerns of the World Bank and the IMF regarding the repayment of their external loans, the LDCs are pressurised into restructuring their economies (IMF, 1986; World Bank, 1981). LDCs can borrow money on the condition that they privatise their inefficient public enterprises (Prager, 1992; Nellis & Kekiri, 1989). They rely heavily on the structural adjustment loans of the World Bank and the IMF (Moseley *et al*., 1991). Further, through bilateral exhortation and their dominant influence on lending policies, also external agencies put pressure on LDCs to liberalise their economies and privatise their public sector enterprises (Moseley, 1988).

War [Political instability]: Another variable that has an impact on a country's economic situation is war. The resulting unstable political climate and the way it influences the economic growth in LDCs is one of the IMF's major topics of study. It is argued that policy-makers behave in line with their own political and ideological objectives when developing policies of taxation, expenditure and monetary expansion (Edwards, 1994). This implies that policy-making is an endogenous variable, which depends on a country's economic, political and institutional circumstances. If the economic and political situation is unstable, the result is inflation, which undermines economic growth. Inflation hinders long-term planning and encourages firms to increase their inventories and debts (USAID/Zambia, 1993)[14]. Political instability increases the problem of commitment and affects institutional self-government. The IMF report of 2003 shows that the effects of the Ethio-Eritrean border war (1998-2000) are clearly reflected in the economy's key variables: growth has declined, inflation has risen, public expenditure and the current account deficit have increased, and the foreign reserves have almost been depleted. Also, due to the rigidity of the exchange rate regime the exchange rate has become subject to duality with a strong parallel market. As a consequence, transparency, competitiveness, domestic

[14] A study by USAID on 'Country Programme of Strategic Planning' see: http://pdf.dec.org/pdf_docs/PNABN964.pdf

growth, as well as the confidence to make investments are being undermined. At the same time, the fact that people are forced to join the military has considerably decreased the size of the work force in Eritrean private firms.

Competition: Given the hostile nature of the competitive environment, formal control and sophisticated accounting instruments are crucial (Khandwalla, 1972; Otley, 1978). Libby and Waterhouse argue that competition stimulates the initiative to change MCS. Yakou and Dorweiler (1995) affirm this, since an insight into costs and performance levels is the key to economic survival. In addition, Chenhall and Langfield-Smith (1998) state that the increase in competition on a global level and the dynamic nature of the business environment requires MCS techniques to be adapted on a frequent basis.

Evidence shows that the environmental uncertainty caused by the system of competition is related to a strong emphasis on budgetary control (Otley, 1978), a reliance on formal control (Imoisili, 1985), accounting, production and statistical control (Khandwalla, 1972). However, in some cases environmental uncertainty is not linked with a strong budgetary focus (Brownell, 1985). And there are also examples of a combination of strict budgetary control and a more interpersonal and flexible approach. Ezzamel (1990) shows that in other cases of environmental uncertainty, budgetary information is used for evaluative purposes by means of variance analysis methods, and there is a great deal of superior-subordinate collaboration. Also Merchant (1990) indicates that the pressure to meet financial targets is related to environmental uncertainty. In addition, Chenhall (2003) observes that hostile and turbulent conditions require formal budgetary control systems.

In summary, we can conclude that management control systems are essential tools for market capitalism, and in LDCs they are expected to take form similar to the way they operate in the West. However, the improvement of MCS requires a number of preconditions, such as market-oriented strategies, pricing and resource allocation decisions, and no state intervention in the management of enterprises. Further, efficient capital markets are required where managers can be sanctioned for inadequate decision-making. Other important conditions are transparent accounting systems and regulation, control structures - free from bureaucratic control – on which both management and employees can exert influence, a well-established labour market, efficient collective bargaining systems, and a climate in which decision-making is based on organizational criteria rather than on personal or political considerations. In general, the impact of factors such as culture, political history and TUs is expected to be minimal (Hopper *et al.*, 2004a).

With respect to the promotion of goods and services as well as the appointment and training of the labour force, the internal labour markets in LDCs are assumed to function just as efficiently as those in the West. No influence is expected of TUs. The market forces create the labour

market. In this context, TUs, as internal state organs, operate within the framework of industrial relations. Private owners/enterprises provide the conditions required for collective bargaining. Further, a relatively transparent, modern and market-oriented accounting system would be introduced to assist firms in their decision-making processes, their reporting practices and the achievement of their overall objectives. However, since the concepts of capitalism and privatisation are relatively new to LDCs and have not yet been fully embedded in their socio-economic structures, the aforementioned predictions may not be valid. What has to be considered here is the reality of LDCs (Hopper *et al.*, 2004a). It is worth to mention in this respect that researchers recognise the necessity of finding out 'what accountants in Third World Countries 'actually do' rather than imposing Western accounting practices upon LDCs (Peasnell, 1993).
Table 2.1 summarises the main issues dealt with in this section. It contains a list of the contextual factors, the key issues related, and the theoretical expectations with respect to market capitalism in LDCs.

2.6 Summary and Conclusions

In this chapter we have dealt with the principles and objectives of the concept of privatisation. We have in particular discussed its outcomes as expected by its advocates and we have stressed the importance of MCS. The empirical evidence provides us with an insight into post-privatisation MCS practices in LDCs. The evidence shows that the actual effects of the privatisation process in LDCs do not correspond with its theoretical outcomes. The expectations with respect to the results of privatisation are based on studies conducted in the West but these studies fail to take the contextual factors of LDCs into account. These factors are generally described as country and market conditions, and they are briefly addressed in this chapter. In addition, although it is generally recognised that privatisation has an impact on MCS and firm performance, the studies conducted so far do not provide a sufficient analysis of the changes taking place.

On the basis of past studies, we may conclude that the research into the impact of privatisation on MCS and firm performance should be conducted from a wider socio-economic, cultural and political perspective. Some of the studies referred to in this chapter do in fact indicate that the success of privatisation programmes and the realisation of effective management control systems depend on a number of contextual factors (see figure 2.1 below). However, they do not provide a detailed analysis.

Table 2.1 *Contextual factors* *that influence the privatisation outcomes (MCS & Firm performance)*

Contextual factors	**Key issues**	**Expectations**
Culture, Race & Ethnicity	- Culture: attitudes, beliefs, and customs	- Modern capitalist attitudes, beliefs, and customs either exist already or will develop; - A large degree of individualism and self-improvement; - The traditional culture will be replaced by a new work mentality: quality consciousness and a focus on continuous improvement; - Employees will positively respond to modern MCS, economic rewards, and labour contracts; - Social homogeneity in the workplace; - Ethnic & racial differences will not hamper the new capitalist system and are considered irrelevant;
State and Regulation	- State regulatory bodies and policies	- To safeguard infrastructures, to maintain law and order, to facilitate financial and commercial mobility, to oil market relations, to prevent market abuse, and to interfere less with the private sector affairs; - Stable policies, legislation and political systems that motivate investment as well as a fair functioning of the financial market; - To solve problems, such as the absence of stock markets and merchant banks, price controls, foreign exchange controls, excessive borrowing by the government, heavy taxation, restrictions to employment, and requirements for the use of local supplies; - To ensure internal and external transparency.
Trade Unions (TU)	- Collective bargaining	- TUs are expected to protect the rights of the employees (with respect to issues such as appointment, dismissal, rewards, sanctioning, raise in salary, benefits, etc), and to stimulate the consensus between the union and enterprises; - Labour markets are expected to discipline labour and stimulate recruitment based on qualifications and training; - Government agencies are expected to develop education and training programmes to increase employees' skills.
Aid Agencies	- Development Loans - Loan conditions set by the World Bank and the IMF, - Advanced industrialised countries	- To encourage LDCs to adopt structural adjustment policies and to assist them in creating suitable business environments by means of privatisation and financial liberalisation aimed at establishing stronger capital markets, introducing export zones, public sector reform, TU activities, party politics, state intervention, developing a market economy, increasing financial regulation and decreasing political intervention; - To assist in the transfer of Western MCS to LDCs.
War	- Inflation, access to foreign exchange, macro-economic and political instability	- Unstable economic and political conditions give rise to inflation, which in turn affect growth, make long-term planning difficult, encourage firms to increase their inventory and debts, and frustrate investment. - An unstable political situation leads to a reduction in employment and the size of the labour force due to obligatory military conscription, which negatively affects productivity.
Competition	- competitiveness of the environment or the market	- A high degree of competition requires knowledge of cost issues, the utilisation of performance measures, formal control, budgetary control, a high degree of participation, and the use of improved MCS. - Competition stimulates a change of strategy, which requires MCS changes.

In our study we use the contextual variables discussed in this chapter to develop our conceptual framework (see chapter 3). This framework is suitable for examining the situation in Eritrea. We hope and expect that our findings will contribute to expanding the body of knowledge in this field and that our research will strengthen the evidence provided by other studies. It is our aim to gain more insight into the actual situation in Eritrea after the privatisation of its economy.

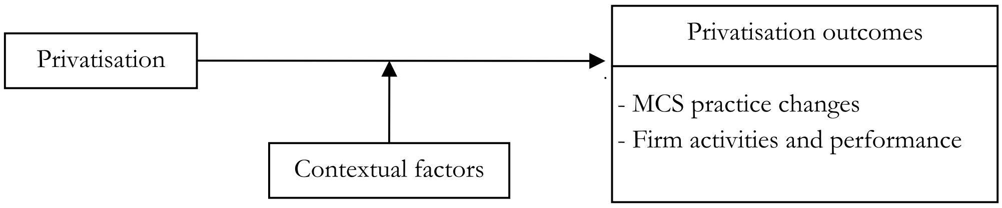

Figure 2.1 *The relationship between privatisation, its outcomes, and contextual factors.*

Both in the West and in LDCs, most research studies dealing with MCS change and firm performance have a narrow focus. They are based on surveys and do not consider the broader contextual perspective. In addition, most research conducted in LDCs only concentrates on a limited number of common MCS practices. We intend to use a framework that enables us to address a broader range of MCS practices adopted in LDCs as well as the internal and external contextual factors.