PRIVATIZATION OF PUBLIC ENTERPRISES IN THE EMERGING MARKET: PROBLEMS AND PROSPECTS

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State-owned enterprises (SOEs) are known to provide service delivery to people because of their lack of profit motives. However, politicians (elected officials) who engage in corrupt practices often use SOEs as cash cows. Simultaneously, SOEs' success drives national economic development and aid in the fight against poverty. The aim of this study was to investigate whether privatization of SOEs can turn around the losses they make and lead to viability. This study employed a desktop approach in which reports, financial statements, and various documents on numerous SOEs were reviewed. The time span used for the reviewed documents was 20 years (2002–2022). The findings of this study indicate that many SOEs in South Africa have incurred insurmountable losses due to corruption and poor fiscal management. Thus, privatization of such entities may look noble, yet it is a short-term fix to the problem.

Keywords: Crowding Out, Efficiency, Nationalisation, Privatisation, State Owned Enterprises

1. INTRODUCTION

State-owned South African Airways lost approximately R16 billion over three years (2017–2020), highlighting the inefficiency of state-owned enterprises (SOEs) (Businesstech, 2020). The financial situation of a Romanian airline steadily deteriorated after the liberalization of the European aviation market. This decline was caused by political interference, poor choices, and naive tactics (Beria et al., 2011). Likewise, Swissair’s decline in the early 2000s was linked to bad merger choices in the past (Knorr & Arndt, 2004). Owing to the dearth of domestic market opportunities and the inability of local governments to establish transportation hubs, state-owned airlines have historically struggled (Burghouwt & Dobruszkes, 2014).

Public enterprises operate as agents rather than principals with profit motives, leading to this inefficiency. Ineffective management, high fixed costs brought on by an excess of workers and wages that are higher than productivity warrants, administered prices, lack of competition, ongoing budgetary support, and subsidized loans from nationalized commercial banks are the causes of this. Thus, public enterprise management is unable to maximize profits because many conflicting and frequently non-commercial objectives must be achieved. The bureaucracy's emphasis on procedures rather than results prevents it from effectively supervising government agencies. This
means that management under state ownership merely adheres to a set of standard operating procedures rather than maximizing profits, raising sales, and gaining market share. Public organizations are subject to "soft budget constraints" imposed by government regulations (Ji et al., 2019). Thus, it is difficult for a funding source to maintain an enterprise at a fixed budget. Public enterprises, like businesses with dispersed ownership, encounter moral hazards when power is shared among numerous individuals. Theoretically, a nation’s citizens are the true owners of the businesses run by the government. Ordinary citizens lack the motivation to carefully examine the actions of managers and employees in the public sector. The private sector frequently has more advanced monitoring capabilities and lower monitoring costs than the public sector does. The budget is out of money and has always supported public-sector investments. Public enterprises cannot access the domestic capital market under the current management structure. For organizations in the public sector, numerous reform and restructuring initiatives have fallen short of improving their performance. As long as public enterprises are not subject to market discipline, statutory and administrative measures are unlikely to address the fundamental issues.

Over the past three decades, there have been two key factors in the rise of state-owned enterprise research. Between the 1980s and the early 2000s, both developed and developing nations launched extensive privatization initiatives (Roland, 2008; Mickiewicz, 2010). The belief that only private ownership can guarantee effective corporate governance has led to massive privatization. Second, a significant portion of the BRICS (Brazil, Russia, India, China, and South Africa) economies is composed of SOEs (Lin & Milhaupt, 2021; Lazzarini & Musacchio, 2018; Organization for Economic Co-operation and Development [OECD], 2015). The interest of international organizations in SOEs has increased over the past 10 years, leading to comparative studies on various national cases (OECD, 2015, 2017), periodic data gathering (OECD, 2015, 2017), and analytical reflections on new governance models (World Bank, 2014; OECD, 2015). The theoretical literature suggests that SOEs may have both favourable and unfavourable effects on growth, and it is still unclear what impact they have on overall economic activity.

This study examines alternatives to privatizing South Africa's SOEs. Although developing nations face a variety of problems, SOE reform in these nations is not our primary concern. We argue that privatization should be considered as one of several options and not the only policy response to SOE underperformance. Privatization is frequently the best answer when problems arise as a result of state ownership. However, many essential elements for successful privatization are frequently absent in developing nations. Only a few of these elements have a stable political climate, low levels of corruption, and vigorous private-sector competition are only a few of these elements. Other strategies, such as outsourcing, management performance contracts, or even closure, may be preferable to privatization when it comes to reorganizing a business. The main lesson learned from this study is that South Africa needs to create and update a reform plan suitable for the nation's current political and economic environment.

The main objective of this study is to determine whether privatization is an antidote to South Africa’s SOEs, which have failed for the past five years, and what the likely outcomes are if they are privatized. Therefore, an empirical approach is required to investigate the influence of SOEs on economic growth. Any government decision could potentially stifle economic growth because South Africa has one of the largest economies in Africa.

The remainder of this paper is organized as follows. Section 2 reviews the relevant literature. Section 3 provides the methodology used to conduct empirical research on SOEs. Section 4 presents an analysis of the research. Section 5 discusses the limitations of privatization. Finally, Section 6 concludes the investigation.

2. THEORETICAL FRAMEWORK

2.1. Endogenous growth theory

According to the endogenous growth theory, investments in research and development (R&D) are critical components in determining long-term growth. SOEs can be used to encourage these investments to accelerate technological advancement (Aghion & Howitt, 1996). Private companies undervest in research activities, considering the peculiarities of knowledge production and spillover (Romer, 1990; Griliches, 1992). Encouragement of R&D in SOEs is one of the many options available for economic policies. Public-oriented SOEs assist in coordinating the dissemination of knowledge within national innovation systems when additional work is required to use existing knowledge to create new knowledge (Nelson, 1993). For large organizations that typically work in upstream industries, SOEs prioritize basic research and long-term projects in their research strategies for large organizations that typically work in upstream industries. Because of these characteristics, SOEs are frequently seen as key figures in knowledge governance mechanisms (Antonelli et al., 2014; Antonelli, 2014). Despite their well-documented advantages and disadvantages, one school of thought argues that SOEs are neither inherently bad nor good. The organizational structure of the companies for which they work has a significant impact on their effectiveness.

Shaheer et al.’s (2017) analysis of SOEs shows that, in contrast to public-owned enterprises, managerial rent-seeking rises disproportionately in companies with weak institutional frameworks. Rent-seeking is defined as a situation in which SOE managers seek to enrich themselves at the expense of failing SOEs. Huat (2016) asserted that three elements — competent management, freedom from bureaucracy, and market competition — are responsible for Singapore's SOEs' strong financial performance. Bartel and Harrison (2005) found that Indonesian SOEs underperform when faced with soft budget constraints; however, their performance can be improved by raising market competition and
reducing government funding. According to Bozec et al. (2002), determining whether SOE’s business goals are influenced by their political principles is crucial.

Based on the reviewed literature, we conclude that there is insufficient evidence to definitively determine whether state-owned businesses have a positive or negative effect on economic expansion. We believe that one of the most crucial factors affecting how SOEs influence the economy is the institutional context. In environments with strong government institutions, the potential drawbacks of SOEs such as agency issues and soft budget constraints are exacerbated, whereas in environments with weak institutions, they are reduced. Consequently, we assume that stronger (weaker) institutions encourage (restrain) positive external effects and increase (distort) SOE efficiency, resulting in a more (less) favourable growth impact.

One might wonder if supporting privatization enables the private sector to enter the market, given the obvious failure of public enterprises. In other words, it draws cash that would otherwise be stashed abroad or used for dubious business transactions. Although the private sector is less likely than the public sector to invest in productive capital, it is still possible to make the case that privatization is advantageous. Privatization has a crowding-in effect on investment because it first increases confidence in the regime’s commitment to pro-property-owner economic policies and then diverts investment funds away from direct unproductive profit-seeking activities (Cheteni & Khamfula, 2018). Of course, this diversion may not always be advantageous to everyone in a skewed regime. It could be argued that public enterprises’ non-economic goals are more concerned with furthering the interests of powerful groups than with enhancing the welfare of the general public. Privatization strengthens market forces while reducing the personal nature of economic transactions.

2.2. Agency theory

What is referred to as the corporate governance of SOEs is influenced by the state’s ownership role, the government’s oversight role, and the agency implications of contracts between the government and its agents. The integration of these structural components is informed by the larger context of regulatory reforms, national interests, public legitimacy, organizational culture, and social impact (Shapiro, 2005). Agents’ lack of incentives to increase their companies’ profits because of the state’s generous subsidies and lax budget constraints contributes to the state’s role as a principal, leading to poor monitoring (Grosman et al., 2016). In emerging economies, focusing on SOEs and upholding agency contracts. Politicians frequently omit the board of directors when making operational and long-term decisions in SOEs (Klausen & Winsvold, 2021).

Numerous studies have examined organizational models and legal modifications that mitigate the negative effects of state involvement in corporate governance (Okhmatsky, 2010). In state-dominated businesses, the principal-agent problem has a long list of potential conflicts, including those between ministers, boards of directors, and company executives (Qiang, 2003). The government can stifle the market by providing subsidies to SOEs or by modifying the laws to their advantage. Because corporate governance structures in state-controlled businesses would interfere with the achievement of political goals, politicians have no incentive to support them (Nem Singh & Chen, 2018).

Political motives can obstruct an SOE’s operational procedures by applying pressure on the board to make contentious decisions regarding investments, procurement, leverage, or employment. SOE managers understand the importance of maintaining a close relationship with the government (Suhomlinova, 1999) because of factors such as decreased bankruptcy risk, tariff protection, subsidized credit, exclusive operating rights in specific markets, early notification of regulatory changes, and an annual influx of subsidies and state aid. The majority of SOE managers are confident that the company will continue operating and that the government will provide sufficient funding for the business to survive even if the managers fall short of their financial goals.

Traditional agency issues related to the separation of ownership and management are eliminated when the state holds a controlling stake; however, this also creates new challenges. Managers who advance the interests of the company are replaced by line ministers unless they have strong connections with the political parties that make up the government (Melis, 2005). The fact that SOEs are exempt from bankruptcy and hostile takeovers will be welcomed by governments that are eager to maintain control over strategic resources. The government is the principal, and its representatives are expected to act in the interests of the state or politicians, which may be at odds with those of the private sector.

Politicians and bureaucrats, who are more concerned with maximizing political benefits than maximizing economic efficiency, are typically assigned board and management positions in SOEs in emerging economies. The phrase “politically embedded” describes how heavily politicians and government officials are involved in the management of SOEs (Grosman et al., 2016). Consequently, politicians may develop strong relationships with particular SOEs, giving them preferential treatment in the form of low or no leverage requirements and high subsidy levels (Cazurra et al., 2014; Cheng & Kung, 2016). Top executives, board members, and government representatives rely on “reciprocal opportunism” in an effort to impose their agenda on SOEs (Apriliyanti & Kristiansen, 2019). It might be necessary to appoint new directors or managers when the political party or organizational structure of the government changes (Kuzman et al., 2018).

The board of directors is responsible for advancing shareholder interests, approving the chief executive officer’s (CEO’s) strategic choices, and focusing on the management team’s performance (Aronson, 2012; Li, 2010). Boards of directors must be endowed with the proper degrees of power,
knowledge, and objectivity to carry out their duties of strategic guidance and oversight (OECD, 2015). However, a board’s capacity to oversee operations may be compromised if state ownership disrupts the government’s political connections. The government encourages organizational hierarchy within a state-owned company by directly appointing the company’s CEO (Borisova et al., 2012). Line ministers frequently attempt to streamline the decision-making process and exercise control when quick action is required. State officials view those in charge of SOEs as being in a subservient position, making them easily expendable. On the other hand, political interference in SOE operations increases agency costs and reduces agent accountability (Ingley & Van Der Walt, 2004).

Homophily, or a premium based on loyalty, trust, and political commitment, is crucial (Opper et al., 2015). Managers and chairs of SOEs frequently belong to the nation’s upper political echelons or strive to do so. Consequently, government officials and members of political parties are frequently appointed to SOE boards of directors. Along with possible conflicts of interest and political allegiances, the lack of transparency in their selections violates the legal requirements. However, having independent directors is believed to reduce corruption (Grosman et al., 2019).

3. RESEARCH METHODOLOGY

The qualitative desktop approach used document analysis from annual reports, strategic and corporate plans, auditor-general reports, and other industry analyses as its foundation. The years 2010–2023 are included in the scope of this study. Using a qualitative desktop approach, the researcher gained a greater understanding of the complexities surrounding governance issues for the vast majority of state-owned entities. Because the primary purpose of the study was not to validate a hypothesis but rather to evaluate lessons and provide alternatives, the qualitative approach was chosen because it was able to provide the analysis as well as the breadth of information that was required for such resonance. The objectivism paradigm serves as the foundation for the qualitative desktop research methodology.

The objectivist paradigm maintains that it is possible to observe social phenomena even in the absence of social actors’ participation. There is a focus on the practical aspects of this matter (Bryman, 2012). As Yin (2009) points out, document analysis is useful because it can confirm and expand upon evidence gathered from other sources by providing a more in-depth explanation of the phenomenon. Therefore, this is a useful tool. In addition, document analysis is typically non-intrusive and comprehensive, and allows for repeated analysis of the results. As a result, unlike interviews, which is another method of data collection, the actions taken by the respondents were not affected in any way. It is essential to note, however, that interviews do not come without their own caveats, particularly in the present political climate enshrined in investigations into state capture.

4. EMPIRICAL FINDINGS

This section focuses on arguments as to why SOEs fail and the likely causes of SOEs failure.

4.1. Abuse of public office and the fraud triangle

Government officials and lawmakers can exert political pressure on SOEs. Different government agencies may pressure SOEs directly when board members express their interests (Du et al., 2012). By giving their friends job promotions and subsidies, political leaders can take advantage of SOEs. SOEs can be used by politicians to advance their own agendas by disbursing funds, enhancing their public image, or granting favours to supporters. A nation’s corporate governance system suffers when politicians use their power over SOEs for private gain. Consequently, agency losses can appear in many forms, including but not limited to corruption, self-dealing, shirking, moral hazard, adverse selection, and moral hazard (Shapiro, 2005). Owing to the state’s unique ownership position in SOEs, agency problems are likely to be more severe than those in private companies. Politicians have two options for interfering with SOE decision-making: directly or indirectly (Qiang, 2003). Governments can foster political ties by appointing executives and board members who share their political beliefs and are therefore more likely to support the party or the government’s stated objectives. Public office abuse occurs when a politician or public official hires a relative, friend, or political ally over a more qualified (Gardiner, 2002; Kuzman et al., 2018). Simply put, a board member or CEO is fired and publicly humiliated if they refuse, disagree with, or challenge government orders (Radon & Thaler, 2005). In SOEs, the board of directors is frequently just a formality, and managers have limited decision-making power (Aprilyanti & Kristiansen, 2019). Therefore, government employees are more likely to use their positions to further their political ambitions and profits personally (Radon & Thaler, 2005).

Politicians who abuse their positions of power include meddling in the SOE operations. We investigate the causes, effects, and prevention of public-sector corruption using the fraud triangle theory. Albrecht and colleagues created the "fraud triangle" theory. The three pillars are opportunity, perceived pressure, and justification. Any fraud or wrongdoing must be given the opportunity to occur prior to committing it. The second factor is the impact of external forces, whether financial, interpersonal, or political (Skousen et al., 2009). SOEs are a prime example of how politicians who fear losing their seats may utilize them in their campaigns (Bozec et al., 2002). Third, after rationalization, fraud accords with the perpetrator’s personal morals. According to Cressey (1953), all three components are present in every circumstance.

4.2. Legitimacy test

A business can be regarded as legitimate if it adheres to normative social standards (Suchman, 1995; Tilling & Tilt, 2010). The pressure to be legitimate increases as more people acquire stock in
a company (Garde-Sánchez et al., 2017). Therefore, it is crucial to examine how corporate scandals affect various individuals and institutions involved in running SOEs. A corporate scandal is a crisis that requires stakeholders to act because it is sparked by dubious action (Sims, 2009). When businesses engage in unethical, illegal, or morally repugnant behaviour, words spread quickly through all channels (Grebe, 2013; Mingus, 2007).

The failure of the board to keep an eye on the CEO's behaviour, too little control in too few hands, board members not having enough influence in crucial decisions, a toxic organisational culture, and a lack of an ethical tone at the top, lack of managerial ability, defects in accounting, reporting, and auditing, corporate criminality, incentives that are distorted and favouritism, inadequate resource management, and an unbalanced corporate strategy.

After a scandal, it may be challenging for a business to gain the support it needs to survive, such as the confidence of its shareholders, the devotion of its staff, the support of investors, the confidence of the public, the confidence of the media, and the confidence of the public at large (Heath & Norman, 2004). When corporate scandals reveal gaps in the application of sound corporate governance mechanisms, organizational legitimacy becomes in jeopardy. Owing to the scandal's extensive media coverage, the public's perception of the company's dependability was clouded. SOEs must enlist the assistance of state representatives to combat the erosion of their legitimacy. Politicians prevent large SOEs from going bankrupt, primarily for economic and employment reasons (Heath & Norman, 2004). Because SOEs are frequently required by various logics, they are prone to corporate scandals (Thornton et al., 2012). They engage in behaviours that pose a threat to their legitimacy, such as those that pit political objectives against those of the market (Battilana et al., 2017). As SOEs attempt to strike a balance between political demands, power, and influence on the one hand, and the pursuit of profitability on the other, conflicts of interest frequently arise. Ministers who maximize their personal gain from their official roles can engage in unethical, illegal, or morally repugnant activities. As a result, the effects of labour shortage are severe. Governments often struggle to establish precise performance criteria for the management of SOEs (Heath & Norman, 2004).

This is likely to be the case in nations with underdeveloped economic institutions. If a sector is economically or strategically important, the government is likely to maintain strict control. The way different countries define strategic industries has an impact on the institutional logic of SOEs (Bruton et al., 2015).

5. LIMITATIONS OF PRIVATIZATION

Understanding the restrictions on privatization is essential. The goal of privatization initiatives cannot be the transfer of all governmental social and economic responsibilities to the private sector. It is possible to increase productivity through better managerial oversight and incentive structures by privatizing public enterprises and establishing the right policy environment. The state's role in South Africa's social policy is unquestionably present even as public enterprises are privatized. This does not imply that a state is ceasing to exist.

5.1. Regulations

South Africa's regulatory environment is precarious. The lack of properly written legislation, skilled workforce shortages, and widespread corruption all contribute to the state's weak ability to regulate. The regulatory framework's goal is to ensure that businesses adhere to minimum contractual obligations and refrain from exploiting customers to make unintended profits. For South Africa, structural regulations based on the application of straightforward rules are preferable to arbitrary flat-based regulations. Structured regulation is preferable to conduct regulation because it reduces the bureaucracy's ability to extort rents. Currently, public enterprises perform their regulatory duties. Prior to privatization, public enterprises would need to have their regulatory bodies spun off. Regulations must be in place in non-competitive markets to safeguard consumers from anti-competitive behaviour. The state has a duty to defend the public interest through regulatory power, which should be used with caution and discretion. In properly regulated industries, monopolies have little scope for abuse of market power. Thus, an effective set of incentives must be available to the private provider of a monopolistic service. Privatization works best in sectors with monopoly structures when accompanied by regulations.

5.2. Debt, default, and privatization

South Africa's state patronage of a small number of wealthy people has led to the development of a debt-default culture. Some of the richest citizens of the nation have borrowed money from development financial organizations but have declined to pay back loans. The privatization program will not be worthwhile unless South Africa's credit policy is changed to a commercial basis because the rent-seeking class will simply purchase public enterprises with public funds, demand public funds to operate and subsidize privatized enterprises, and syphon off wealth for private accumulation at the expense of the public.

5.3. Excess employment in public enterprises

When there is a high labour shortage, the social cost of labour is lower than the going rate (Sen, 1975). Because the social marginal cost of output is lower than the marginal private cost of output, the private sector will employ too few people, resulting in lower output. In this case, privatization reduces welfare if it results in job loss. However, public businesses may also hire extra labour because of their patron-client relationships. As a result, the effects of labour reduction caused by privatization may differ. According to Bhaskar and Khan (1995), the pattern of excessive employment in South Africa's public enterprises is a manifestation of patron-client ties. If excess employment resulted from vertical ties, there would be a significant number of unemployed white-collar workers; whereas, if it resulted from
social welfare concerns, excess employment would be concentrated among blue-collar workers. According to an analysis of changes in the number of employees across different categories following privatization, vertical ties, rather than social welfare considerations, are to blame for overstaffing in public enterprises.

5.4. Corruption and rent seeking

The government must address administrative inefficiency and corruption to reform its portfolio of SOEs (Smith & Trebilcock, 2001). If ethical business practices and a board-level ethics committee are implemented, a full-blown scandal may be avoided in the future (Ingleby & Van Der Walt, 2004; Yoon et al., 2012). SOEs are usually involved in a number of unethical practices; therefore, implementing a code of conduct in SOEs is one way to reduce the prevalence of cronyism, favoritism, and nepotism there (Arasli & Tumer, 2008; Du et al., 2012).

The adoption of a corporate governance code should lead to increased accountability for all system actors and board independence (Robins, 2006). Appointments to board positions should be based primarily on candidates' specialized competencies, and the management of SOEs should be given true autonomy. If they are not politicians or bureaucrats, SOE board members will be held to higher standards of performance and accountability (Klausen & Winsvold, 2021).

Only if the government and market participants conduct exhaustive background checks can the competence, dedication, and faith of board members be assessed. The state is in charge of creating systems and guidelines that support risk management, internal controls, and overall compliance; however, it is the board's job to ensure that corporate representatives behave scrupulously and honestly (Crête, 2016).

The government sends the message that it will not meddle in business affairs when it names experienced executives to lead SOEs (Cazurra et al., 2014). Meanwhile, market forces can contribute to ensuring sound corporate governance with less government interference, most notably through the 'comply or explain' mechanism (Grosman et al., 2016). The powers of the CEO and owner must be subjected to external checks (Bozec et al., 2002).

In nations with high levels of concentrated ownership, inadequate legal protection for stakeholders and inefficient capital markets frequently occurs (Yoshikawa et al., 2014). The corporate governance system becomes a battleground for opposing interests and ideologies, especially when SOEs are perceived as political vehicles (Ingley & Van Der Walt, 2004). A governance system that can successfully manage conflicting interests is required because of the multilevel agency relationships and competing economic, political, social, and personal goals.

6. CONCLUSION

South Africa must adopt and implement effective privatization policies to increase economic growth and fixed capital formation, build infrastructure, and enhance the quality of life of its citizens. Directly preventing unproductive profit-seeking activities that impede economic growth and development must be the goal of the state’s privatization policy. A crucial first step in restoring an economy’s ability to invest in faster rates of economic growth and development is increasing the economic efficiency of its enterprises. The transition to a new economic system that supports South Africa’s economic growth and development must include privatization. A privatization policy must be properly designed and implemented to ensure that businesses function effectively after privatization. The transfer of company ownership from the public to the private sector is less important for improving performance than a change in corporate governance. Privatization can support growth and development when it occurs under favourable circumstances, where economic actors’ profit motives are directed toward productive activities rather than rent-seeking and corruption. However, privatization is not a requirement for enhancing firm performance. Therefore, policies establishing a market order that encourages economic growth and development in South Africa should be implemented alongside privatization.

The foundation of an effective government is trust, which comes from predictable and impersonal institutional behaviour. The legal environment is especially important for SOEs because trust in countries with civil law depends on regulations. Central and Eastern European countries are characterized by lax regulations and/or lacklustre openness (Dumitru et al., 2017). Although laws govern the management of SOEs, the state, as a shareholder, can occasionally circumvent them. At the national level, trust based on accepted norms is comparable to the rule of law, whereas favouritism and conflicts of interest in the business world are reduced through self-regulation (Alon & Hageman, 2017).

To create a situation in which agents’ incentives are in line with state goals and the public interest, agency conflicts must be resolved (Jia et al., 2019). The government must choose between three options: commercializing the organization while maintaining state control, privatizing it entirely or in part, or keeping public funds flowing into the SOE's budget despite losses or inefficiencies (Heath & Norman, 2004; Rentsch & Finger, 2015). The only option, commercializing the company under state control, is the most difficult to implement because it calls for changes in corporate governance that might conflict with political objectives. Finally, the ability of the state apparatus to put an effective monitoring system in place determines whether SOEs can be commercialized (Cazurra et al., 2014).

The limitations of this study were that many government publications were suppressed or hidden from the public, and as a result, periodic reports and newspaper articles contributed to the study. Moreover, the topic of SOEs in the sub-Saharan region has not been extensively researched because sensitive information is suppressed by governments. This study is important for informing policymakers on what to expect when SOEs are privatized in South Africa.


