THE POLITICAL ECONOMY OF PRIVATIZATION: ASSESSING THE IMPACT OF THE FINANCIAL SECTOR ON THE ISSUES OF EQUITY AND EFFICIENCY

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SUMMARY

The political economy of privatization in developing countries is inevitably a complex and highly contextual one. Abasic element in assessing the process is to understand the role and structure of the financial sector. Governments generally state at least two objectives for their privatization efforts: economic efficiency of production through change of ownership and an equitable distribution of state-owned assets. The nature of the financial sector can determine in a significant way the conditions under which the goals of equity and efficiency are achieved. The author argues that the more market-oriented a country's financial structure, the less problematic the privatization effort is likely to be and the more transparent its political economy.

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INTRODUCTION

The political economy of privatization in developing countries represents a complex and dynamic pattern of shifting coalitions and changing interests. Some have argued convincingly[1] that privatization itself represents only a small part of larger and far more contentious structural adjustment packages. The degree of difficulty it entails, however, makes the process of privatization more sensitive, in many respects, to other adjustment measures which are largely "stroke of the pen" policy decisions.[2] Arguably, the privatization process involves a significantly less transparent set of elements which make its political economy both highly suspect and deeply controversial for many developing country populations. As with most economic policy adjustments, the processes of adopting and implementing privatization reforms remain highly contextual. In other words, the degree to which reforms are introduced successfully depends largely on the form and legitimacy of the government undertaking them, the nature of the reforms themselves, the strength of competing coalitions for or against them, and government's actual objectives versus its stated ones or those perceived by the public. A comprehensive study of the political economy of privatization would be lacking if it did not include those elements.[3] Likewise, the *type* of assets to be privatized itself is an important element in assessing the political economy of the action.[4]

Perhaps the most important components to understanding the political economy of privatization are the *nature, structure, and power* (both political and financial) of the numerous coalitions affected by any particular privatization action. To be sure, each of these components, in varying degrees, frames the context for privatization and each helps to shape the political economy of the process. Yet the key to understanding the political economy of privatization and its dynamics lies in understanding the composition, motivation, and influence of the groups which are most affected by the privatization decision. The political economy of privatization is, therefore, a complicated process, defined by a complex interlacing of technical, financial and political factors. In combination, the dynamics of the interactions between and among them determine policy successes or failures. Each of these multifaceted components is equally significant for understanding the complexity of the political economy which they form.[5]

This essay briefly reviews only one such component. It addresses, broadly, the potential contribution of the financial sector in shaping the political economy of privatization. Some have argued that the financial sector as a contributing factor to privatization's political economy and the usual "thinness" of capital markets is relatively insignificant. [6] While it is true that LDC stock markets are typically "thin" and not currently viable mechanisms for efficiently distributing equity, it is equally true that the broader financial system[7] is an essential element for successful privatization and meeting the government's goals.

The logic of the argument which charges the financial sector with a significant role in shaping the political economy rests upon one basic assumption. That assumption, supported by a significant body of empirical evidence, is that the "equity" of privatization is a central concern of government in structuring its privatization objectives. The "equity issue" is perceived by governments as critical either because of an ideological belief that the process *should* be equitable, or it emanates from an understanding that the political implications of divesting or otherwise transferring assets (or control of state assets) to the private sector is divisive, polarizing, and creates rent-seeking opportunities which should be countered.

The thesis of this essay suggests that in most privatization activities in developing countries, equity[8] as well as economic efficiency issues drive the privatization process. Those issues tend to be an important, perhaps even central, preoccupation of government. The nature and scope of financial services for assuring equitable distribution and for establishing economic efficiency, therefore, can significantly influence government decision-making and alter the nature and direction of the political economy of privatization.

FRAMING THE EQUITY AND EFFICIENCY ISSUES

Governments endowed with the legitimacy bestowed by the governed, or governments that wish to develop it, are faced with a plethora of issues ranging from access to voting rights (as in South Africa) to constructing appropriate forms of representation (as we see in the Newly Independent States of the Former Soviet Union) to calculating the appropriate distribution of society's wealth. It is this latter category into which government's concerns about equity fall.

Developing country governments are presumed to be concerned about legitimacy partly because legitimacy imparts and is correlated with a degree of *regime sustainability*. Truly participatory democracies, for example, are inherently more politically stable than other forms of governance precisely because the principal-agent relationship is clearly structured where the governed (principal) have a direct effect on the actions of the governors (agents). The higher the level of legitimacy through public participation in choosing government, the greater the likelihood of regime stability. Therefore, governments are usually concerned to some degree about the impact of their decisions on the populations they govern. [9] [10]

In privatizing state assets, distributional equity is usually, if not universally, a central concern of government. For example, Costa Rica's privatization process of the CODESA state-owned enterprises, which began in the early 1980s, has centered on the distributional question for nearly a decade. The Costa Rican government has been concerned about diffusing the concentration of wealth in its society, eliminating monopoly power, and establishing an opportunity for the equitable access of its citizens to state assets. In 1972, Costa Rica's government adopted Law 5122 establishing CODESA as the holding company for parastatal industries, stating as its objective the strengthening of Costa Rica's private sector. Under the administration of Daniel Oduber (1974-1978), CODESA grew rapidly because it had unchecked loan access to government-subsidized credits. CODESA quickly became an instrument for poorly conceived and badly managed government investment projects. By 1984, CODESA's borrowing from the Central Bank accounted for over one-third of the Costa Rican government's entire public sector credit while contributing only 1 percent of the nation's GDP and less than one half of 1 percent of the country's employment. Its accumulated losses exceeded US $105 million. By 1985, CODESA's holdings consisted of 30 subsidiaries (owned 51 percent or more by CODESA) and 12 affiliates (owned 50 or less by CODESA).

In June 1984, due to mounting budgetary constraints, fiscal losses and pressure from international donors, Costa Rica's government agreed to develop a divestiture strategy for CODESA. To begin the process a new law was required which eventually culminated in the enactment of legislation entitled The Law of Financial Equilibrium for the Public Sector [Law 6955] of 1984. In 1985, donor resources began to support CODESA's divestiture effectively starting Costa Rica's first major privatization of state enterprises. By April 1993, only four CODESA holdings remained out of an original 42 companies. The divestiture or liquidation of the 38 companies was planned and executed by FINTRA, a U.S. Agency for International Development-financed trust (not unlike the U.S. Resolution Trust Corporation but on a much smaller scale). In 1991, to complete the privatization process, FINTRA, acting as an advisor to the government, had drafted a new bill removing the remaining legal obstacles to completing CODESA's divestiture. The bill was adopted by Costa Rica's legislature in February 1993 and signed into law by President Rafael Calder \n in March, adding the final page to a costly CODESA saga after substantial and contentious debate over methods to assure distribution to producer cooperatives, small shareholders and other Costa Rican interest groups.

While reducing fiscal deficits and curtailing future losses was the primary *technical rationale* which motivated Costa Rica's privatization, the government's overriding *political* concern was the *equitable transfer* of state assets into private hands. It was this issue around which Costa Rica's political economy of privatization was formed. The country's privatization decisions were shaped by a *political* preoccupation over the nature and extent of distribution. As a "legitimate", representative government, it was (and is) difficult for Costa Rica's political leaders to enter the privatization debate without the *equity* issue becoming a central theme in their proposals.[11]

The degree of government legitimacy and the effectiveness of the country's representational system, in large measure, will establish the level with which the equity objective enters into the political economy mixture. The higher the degree of government legitimacy, the greater its concern for equitable distribution and general welfare of its citizens. The greater the government's emphasis on citizen participation in privatization, the more important the role of the financial system becomes in framing its political economy, as will be discussed later in this paper.

Another facet of the equity objective is the degree to which equity played a role in the formation of the state's enterprises in the first place. For example, governments with socialist sentiments in the process of converting to market-based economies have been accustomed to framing every argument in "equity" terms.[12] Leaders in transitional economies point to the failure of past ideologies where, in order to "assure equity," the state owned and managed all production for the benefit of only a few but to the ultimate disadvantage of all. As socialist ideology is rejected and the transition to newly emerging market systems begins, "the economic efficiency objective" is now cited as the predominant justification for privatization actions.

Yet in the transition process the opportunity for equitable participation of the public in state-owned enterprises continues to be problematic and is a concern of government. The newly emerging market economies, for example, go to great lengths to preserve equity participation. Privatization schemes are carefully designed to assure some level of popular distribution of equity.[13] On the other hand, governments which have been largely market-based in historical terms (e.g., U.K., U.S., and Canada, etc.), while strongly citing "efficiency grounds" and "limiting the role of the state" as privatization rationales, are *equally* likely to focus on equity issues. In a market-driven system, however, an infrastructure has been developed and has evolved to a level of sophistication where a "market economy" and the price system it employs act as the clearinghouse to ownership distribution. Citizens have equal opportunity to access information and capital resources. Appropriate government intervention prevents market failures, discourages monopolistic control through suitable levels of regulation, and reduces information asymmetry between the market "insiders" and the general public. Essentially, the equity objective is intrinsically problematic to the privatization process *regardless* of the past ideology of the state.

Less contentious is the economic efficiency objective. It can be perceived and debated as a "neutral" [14] policy goal and is therefore used as the vanguard or overarching and more transparent privatization objective. However, as some analysts have suggested, ideological beginnings of state enterprises can be important determinants of the environment and contexts in which privatization is attempted and for understanding the various limitations imposed by past predilection for achieving both the equity and efficiency objectives.[15] More important to the privatization process and certainly to the nature of its political economy is the general preoccupation of governments with *opportunity* for equitable access to assets which are perceived as "belonging" to the public. Overlooked as an important factor in determining privatization's success, a functioning financial sector can contribute significantly to a solution for governments seeking to broaden public access to meet equity objectives and in providing transparent and appropriately valued transactions to meet economic efficiency goals.

THE ROLE OF THE FINANCIAL SECTOR

How does the financial sector contribute to meeting a government's concern regarding economic efficiency and providing opportunities for equitable participation? If "equity" and "efficiency" are fundamental privatization objectives of government as the premise of this essay suggests, then the next step is to explain the financial sector's role in influencing the political economy of the privatization process, and consequently, in creating the *opportunity* for equitable and efficient participation which governments seek. An often overlooked or misunderstood aspect of the political economy of privatization is that the structure and effectiveness of the financial sector can be essential to the sustainabililty and effectiveness of *both* objectives of equity and efficiency,[16] whether governments want to assure fair opportunity to own assets or simply to provide equal ownership to all. It should be remembered that a relatively simple change in ownership of a productive enterprise itself is not sufficient to assure that *equitable participation* has occurred or that economic efficiency will result. For example, widely disbursed ownership can dilute management control which affects the nature of the principal-agent relationship between the firm and its owners. Conversely, excessive concentration of ownership can lead to monopoly abuses which deny both efficiency of production and equity of participation. To achieve the equity objective, then, a functioning financial sector can play a valuable role in *defining* the privatization process: for it is the financial sector that ultimately establishes the mechanisms and wherewithal that provide the opportunity for citizens to participate fairly in a privatization action.

It is also financial services which can assure economic efficiency through market-determined valuation for share prices in the broader, macro level and for production inputs on the factory, micro level. Financial sector services provide *access* to capital resources for the general public, create alternative investment options, and help the investing public weigh the risks and the opportunity costs of financial decisions. Conversely, the absence of a functioning financial sector erodes the government's ability to provide its citizens with the opportunity to participate in purchasing shares because, by its absence, it limits access to resources to only those with accumulated wealth.[17]

Even if shares are distributed freely to each citizen or vouchers are provided to each individual in the hope that the piece of paper (which represents ownership) fulfills the government's equitable distribution concern, the absence of a freely functioning financial system which intermediates transactions between shareholders and would-be shareholders (sellers and buyers) will severely limit participation. The lack of capital markets impedes efficient transactions.[18] Capital market intermediation reduces the costs of transactions by efficiently identifying buyers and sellers, expediting transfers and providing information about the underlying value of the assets. The broader market-based financial sector, of which capital markets are an important part, provides the opportunity for equitable access to the general public for participation in a privatization action because it creates a *basis for competition* for assets (bidding), establishes the *appropriate prices for capital*,[19] and provides *liquidity to individuals* to meet their investment (borrowing) goals.[20] Privatization is the process through which ownership is changed to achieve greater goals of efficiency and equity. Yet, it is the *introduction of competition* into the equation which forces efficiency, *not* the change in asset ownership. A functioning market-driven financial sector establishes the mechanisms for capital competition and, hence, forces efficiency, both in allocating ownership of the means of production and in the production process itself.

As Goldstein and Gultekin point out,

privatization is the re-establishment of the links of factors of production to capital markets and a change in ownership from public to private hands. Changing only one of these factors, however, will not necessarily achieve either the equity objective for fair participation in owning assets or appropriate linkage to the financial sector to assure efficient valuation. Transferring ownership through the purchase of state-owned assets by the private sector will not help to meet the efficiency objective if, for example, the price system is determined by government edict, *uncompetitively*, rather than by market forces. Under such a circumstance, the information about the real value of capital assets, as well as the underlying value of any security, would not be truly reflected in their prices. Therefore, an efficient basis for the general public's determination of appropriate value of opportunity costs and returns, or allocative decisions, is distorted by uncompetitive, government-imposed signals.[21]

Success in achieving the government's objectives will be difficult to obtain in the absence of market-based pricing mechanisms. Without the opportunity for the market to assess the true value of the underlying security of a state-owned enterprise, without the institutional mechanisms to shift ownership shares competitively with minimal cost, and without adequately regulated, accurate, and timely disbursed information, both the opportunity for participation and a shareholder's capacity to fairly determine underlying values will be seriously constrained. Hence, if equitable participation and efficiency are truly the main objectives of the privatization process, then the opportunity to achieve them is greatly enhanced within a market-based financial system.

IMPACT ON THE POLITICAL ECONOMY

> *A prime U.S. objective is liberalization of services, which would allow supranational banks to displace domestic competitors and thus eliminate any threat of national*

> *economic planning and independent development. The agreements impose a mixture of liberalization and protection, designed* ***to keep wealth and power firmly in the hands of the masters*** *of the 'new imperial age'.* [Chomsky, 1993, p. 414]

Privatization is a tool of government, *a means to an end,* ideally characterized by increased production efficiencies and equitable participation in ownership. Yet in writing about the North American Free Trade Agreement, Noam Chomsky at once demonstrates the fear surrounding decentralization of financial services and the rhetorical ideology of the political economy surrounding privatization of the financial sector. If anything, the liberalization of services seeks to *disburse* wealth and power in order to introduce competition as the basis for efficiency.[22] True competition requires financial markets to function as a price and information transmitter.[23] In order for a market-based price system to work, however, markets must be free to determine prices while capital must be accessible and available to support the investment decisions of individuals. Without a functioning, market-based financial structure, the valuation system breaks down. It breaks down because the signals for prices are determined by non-market, government interventions which are motivated by short-term priorities in which decisions are characterized by political rather than technical criteria. The liberalization of the financial sector to which Chomsky refers shifts the Mexican political economy by introducing competition into its nationalized financial system. The privatization of Mexico's banking system has, in its own right, altered the political economic landscape by ceding a degree of government control to private hands, increasing competition, and thereby forcing efficiency. It has also shifted control of the financial sector and its resources to the private sector.

The nature and extent of control of the privatized enterprises is itself an issue in the political economy (which groups or individuals get what benefits).[24] The existence and appropriate functioning of a financial sector, including the development of a capital market, can make the privatization process efficient and meet the objectives of both equity and efficiency. However, government's reluctance to relinquish or otherwise dilute its authority over financial services in favor of a freer market inhibits and may even prevent efficient privatization *even though* by decentralizing its control, introducing competition, and freeing market forces, government's stated privatization objectives of equity and efficiency would be better served. Maintaining control of financial sector functions, however, is often perceived by government to be so much more important to other areas of governing that it is unlikely to restructure the financial sector primarily for the purpose of facilitating privatization objectives.[25] This paradox underlies privatization's political economy.

The levels at which financial markets operate, therefore, affect the political economy of privatization in both obvious and diffuse ways. First, the *opportunity* for the general population to access capital and thereby participate fairly in ownership opportunities is affected by the nature of financial markets. The state of financial services is a defining element of privatization's political economy because accessibility and availability of those services either favors or discriminates against different groups. The greater the monopoly position of the sector (by government or the private sector), the higher the rent-seeking opportunities and the more restricted the access to resources. Therefore, understanding the nuances of how the sector functions should be an important policy issue for governments when designing a privatization program. Second, the level of sophistication and operation of financial markets largely determines the *efficiency and equity of transition* from inefficient state-oriented models of equity distribution to a model where individuals determine their own consumption and investment patterns. Third, financial market operations can either restrain or encourage the disposition of shares in productive assets. Distributional impacts are important to efficiency and require a balance to avoid the extremes of monopoly, on the one hand, or lack of management control because of too many owners, on the other.[26] Finally, the basic lesson is that when the financial sector becomes, to a greater extent, an agent of the government rather than a duly-regulated agent of the marketplace, the political economy of the process changes in ways which can inhibit efficient and equitable privatization.

CONCLUSIONS

This essay has argued that the political economy of privatization in developing countries is inevitably a complex and highly contextual one even within the relatively broad framework defined for this discussion. One basic element in assessing the process is to understand the role and structure of the financial sector. In framing the argument, the essay's thesis has assumed that governments generally state at least two objectives for their privatization efforts: economic efficiency of production through change of ownership and an equitable distribution of state-owned assets. One important but frequently overlooked component to the relative success or failure in meeting the government's privatization objectives is the nature of the financial sector which can determine, in a significant way, the conditions under which equity and efficiency are achieved.

Economic *efficiency* in production is an important objective of privatization as governments struggle to reduce expanding fiscal deficits. The efficiency objective, however, is achieved by the *introduction of competition* and relies upon, as its motivating force, the incentives conveyed by changing vested interests (ownership) from the public sector to the private sector. Selling government assets to the private sector can be relatively easy, but the transference of ownership alone is not likely to achieve the efficiency objective. If the financial sector is responding to predominantly government-dictated priorities rather than market-based ones, inefficiencies will still persist and the new private owners of the enterprise will face many of the same constraints to efficiency as the past government owners encountered. When interest rates are not reflective of real capital costs, when politically motivated lending and borrowing is the norm and absence of capital markets cause high transaction costs, then a change in governance of the firm from pubic to private hands will not resolve the economic efficiency of production. Perhaps government's deficit will be reduced as subsidies to the previously state-owned firms disappear, but the basic, overall inefficiencies in production will likely remain high.[27]

The *equity* objective of the privatization process is an equally powerful element in understanding the political economy of privatization. The perspective that all its citizens should have an opportunity to share in the ownership of state-owned assets is an often stated goal especially in the newly emerging market economies, which complicates the process of divestiture. Legitimate governments view the opportunity for equitable ownership as a primary responsibility and rightfully so. However, the equity objective can also be helped or hindered by the financial sector's operation. An inefficient financial system, which is usually characterized by high government intervention, restricts individual investment decisions. It does so because the pricing signals for determining the real value of assets and opportunity costs of alternative investment are distorted. A highly interventionist state system also discourages market signals regarding the allocative efficiency for capital resources. Lack of capital markets inhibits transactions between borrowers and sellers and drives up the costs of information. Absence of timely and accurate information regarding the underlying assets of the firms to be privatized is yet another result of the failure of a state-dominated financial system. Each of these factors is important for assessing the political economy of privatization and in structuring a privatization strategy.

The political economy of privatization, therefore, is intricately linked to the behavior of the financial sector in which the privatization is undertaken. The precise manifestations of the political economy, however, depend upon the complex mixture of the *nature and legitimacy* of government, its stated versus its implicit objectives, and the degree to which equity concerns are balanced with efficiency goals.

In essence, the lack of a market-oriented financial system can frustrate government privatization objectives by increasing the opportunity for economic rents. In its absence, relevant and timely information is unavailable, transaction costs are excessive and state monopolistic practices in the financial sector promote economic distortions. The more market-oriented a country's financial structure, the less problematic the privatization effort is likely to be and the more transparent its political economy. Conversely, the greater the degree of monopolistic or oligopolistic control and manipulation (by the state or private sector) of the financial sector and the further its distance from competitive market forces, the more contentious, diffuse and obscure the political economy of privatization is likely to be.

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ENDNOTES

1. See Bienan and Waterbury, "The Political Economy of Privatization in Developing Countries," *World Development.* 17:5 (1989): 617-632.
2. The adoption of a crawling peg devaluation policy, for example, a typical stabilization measure, simply requires an administrative edict to be effectively adopted and implemented. Additionally, many "stroke of the pen" policy adoptions can claim to be "neutral" because the total economy is affected in the same way; i.e., local currency loses its purchasing power relative to foreign exchange. Different interest groups will obviously benefit more or less from a devaluation, (i.e., exporters gain, importers suffer) but the transparency and apparent "technical neutrality" of the decision can help to earn support and sustain the reform. The privatization process cannot make such a claim.
3. For example, the decision-making process for privatization undertaken in a totalitarian regime is usually different than one carried out within a democratic one. In the former, government edicts and favoritism usually dominate the process while in the later, public sentiment and interest group influence are publicly debated. The legitimacy of the reform-adopting government, therefore, can play an important role for both privatization as a policy option and in its sustainability through either public support or public opposition.
4. For example, privatization of the education system is distinctly different and far more complex and potentially divisive then say, the privatization of a cement factory.
5. In a sense, privatization is a political process *first* with economic and social consequences rather than the reverse. This is not to imply that economic and social rationale are not the motivating and driving objectives of privatization. Economic efficiency and equity are often government privatization objectives. Rather, the success of the privatization process depends first on the political will to undertake it and the nature of the coalitions which form in support or against it, which is often difficult to anticipate.
6. For example, Bienan and Waterbury (1989) comment that "...By and large,...the stock market is not likely to be a major vehicle for implementation of privatization in LDCs..." (620).
7. The" broader" financial system is taken to mean those services of intermediation which provide access and availability to capital, savings options and other services. It also is taken to mean prudential regulation and supervision which protect investors, mandate transparency in transactions, and which reduce asymmetry in information dissemination.
8. In some notable cases, such as Korea, Brazil and Chile, inter alia, "equity" was not the main issue but the main excuse for privatization.
9. Granted, this description may not account for the behavior of *all* regimes in *all* developing countries but its premise is sufficiently applicable to establish an argument for demonstrating the significance of the financial sector in determining the political economy of privatization.
10. For example, in Pinochet's Chile, it is unlikely that "equity" concerns played a major part in determining that country's privatization decisions. In fact, if distribution of assets was discussed at all in terms of equity, it was most likely centered around which of the select private sector groups would be eligible to access state assets rather than a concern about the welfare effects of distribution on the general population.
11. For an elaborate and interesting analysis of Costa Rica's privatization process from 1972-1993, see *CODESA: Origen y consecuencias (*1993, San José: FINTRA).

12. After all, Marxist socialism was based upon an ideology which believed that, "To each according to his need. From each according to his ability." In other words, everyone is entitled to what they require as determined by the "state" (equitable distribution) and, in return, to contribute to society what they could. The neo-liberal ideology, with apologies to Marx, might be summarized by the following: " To each according to his productivity."
13. Voucher systems, mutual funds, or simply giving every citizen a equal share are three commonly employed methods in the newly emerging market economies of Poland and Russia.
14. In this context, "neutral" is taken to mean that the effect of economic efficiency is broad-based in

its impact rather than implying that there is no effect at all.

15. See Bienen and Waterbury (1989): 623-624.

16. It should be noted that the "*opportunity* to share" in privatization is not the same thing as "*assuring* equal and full" participation of the public. The two concepts are distinctly different. In the first, opportunities for broad-based participation can be created, but require functioning intermediation systems and developed infrastructure such as stock markets, financial instruments, regulatory agencies, and open information flows. Under this scenario, the likelihood for *equal opportunity* to participate in a privatization action is heightened if not assured. Rather than altering existing structures or creating new systems to provide *access opportunity* for all citizens, the second concept relies instead on designing methods *which assure* equal ownership for all citizens through mechanisms such as direct distribution of shares or a voucher system. In fact, methods which seek to "assure" equitable ownership may not be either equitable or efficient.

17. Wealth in developing countries is often concentrated among elite groups that can rely on their own resources. Capital can also enter from abroad by foreign investors which generates a different set of issues.

18. See Goldstein and Gultekin, (1992): 1-6. Without "thick" capital markets, transactions costs for individuals are excessively high. High transactions costs are the result of the lack of information about who wishes to sell and who wishes to buy. More importantly, transactions costs increase without a functioning capital market because the costs of obtaining information about the underlying securities themselves are extremely inefficient.

19. For example, interest cost of borrowing money versus the future expected value of investment returns of equity shares, (both in capital gains and in dividend) can be evaluated by potential investors.

20. Of course, a state-dominated financial system could provide the same services to the general public. However, state owned systems are notoriously inefficient because of asset allocations largely made on politically motivated criteria rather than based on market criteria confusing principal-agent relationship (see Aharoni, 1982). The market's pricing mechanism quickly becomes distorted because of government-mandated credit limits, directed lending schemes, negative real rates of interest and fixed exchange rates, etc. Ultimately, the general population is disadvantaged rather than helped through higher rates and poorer service and unsustainable government deficits. See also Von Pischke, *Finance at the Frontier (*World Bank, 1991).

21.Functioning, market-based financial structures, on the other hand, signal *allocative* and *production* efficiencies to the market. The *production* efficiencies of firms can frequently adjust to distorted markets by changing to a new point of tangency on the production curve. Allocative efficiencies which indicate macro-level scarcity, however, become distorted with government intervention, regulation and political manipulation.

22. Economic liberalization policies, by definition, reduce rent-seeking opportunity by forcing competition. Liberalization policies are designed to break up inefficient monopolies, lower tariff barriers, and introduce a rational exchange regime into previously "protected" economies. In so doing, power among coalitions is redistributed as vested interests shift while opportunities for generating wealth by a larger and different segment of the population are created by introducing a more "level playing field".

23. For example, it is implicit in market-based economics that opportunities are produced by demand and supply with the price mechanism acting as the filtering system and the signal for changes in levels.

24. The "control" of the financial sector is, therefore, a key element to understanding why governments often resist financial sector restructuring. The reasons lie in the principal-agent relationship between government and the financial sector. Which groups benefit or lose when interest rates are raised to reflect real costs of capital? Who gains when prudential supervision regulates equity trading, or when allocation of banking resources is left to the discretion of the private banks rather than Central Bank edicts? What groups profit from opening the country's capital account and competition is introduced for both capital and information services?

25. Financial sector control by many LDC governments is viewed as critical to managing the economy. Governments dislike relinquishing their authority over capital flows, over direct

lending to politically privileged or economically disadvantaged groups and over interest rate manipulation.

26. The issue of the principal-agent relationship and transaction costs can easily overwhelm any potential efficiency gains which the transfer of ownership from the state to the private sector may have conveyed according to the Capital Asset Pricing Model. Ideally, there is an *optimal* number to distribution of shares of company. 100% ownership by a single individual should be avoided but so should over dispersion of shares which limits effective management control because of lack of sufficient vested interests. See Goldstein and Gultekin (1992): 6-21.

27. While production efficiencies will improve somewhat with the transfer of ownership as the new private owners change the production function to meet domestic economic realities, the basic imbalance in *allocative* efficiency in the overall economy created by distorted government policies which affect interest rates, credit allocations, lending mandates, and monetary policies, etc. will limit the efficiency improvements that individual managers can make in their production.