



The Economic Impacts of Privatization

Final Report

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Elliot Berg
L. Gray Cowan
Espedito Gasparo
Lauren Rawlings
Paige Snider

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EXECUTIVE SUMMARY

This report addresses the question: How can the economic impacts of privatization be better assessed? The question arises from USAID's commitment to results-oriented programming and its awareness of the limits of existing assessments of privatization programs. These tend to lean heavily on criteria such as numbers of privatization transactions completed. However, completed transactions represent the bottom line in only a very limited sense. A privatization project, program, or policy is intended to have **effects**, such as changes in methods of management, investment levels, employment, profitability, and enterprise efficiency. Most important, evaluations seek to determine how divestiture transactions affect efficiency, economic growth, and income distribution — the true bottom lines. **Impact** assessments that go beyond first-round results are essential for better definition of privatization's place in USAID's priorities.

Researchers have difficulty distinguishing the effects of privatization from those of concurrent changes in the macroeconomic environment. Privatization is recent in most parts of the world, limiting experience in time and excluding the great bulk of the developing world. We found no country study using time series analysis to estimate the impact of privatization programs on national GDP, rates of growth, or income distribution; nor were there cross-section regression analyses. Studies treated equally the cases of insider privatization and partial privatization (which do not change managerial behavior) with those intended to affect efficiency. **Political** and intangible goals are conspicuous in privatization decisions but unstudied: in the long run, it would be hard to accept as **successful** a program that did not increase efficiency and growth and/or reduce poverty. Besides these conceptual problems, both data reliability and problems associated with selecting appropriate proxy variables for economic impacts raise questions about estimation procedures.

Indeed, due to these severe practical and methodological constraints to an accurate measurement of privatization's impact which are discussed in this paper, it is premature to provide a **handbook** or even detailed guidance on how to measure impacts and second-tier effects. Donor organizations have at their disposal some of the best minds in the area of development economics, macroeconomic impacts, and privatization. These expert researchers should not be bound by one uniform method of measurement as there is still much to be examined. Rather, researchers should be allowed, and even encouraged, to test new assessment methodologies. They should be asked to continue to refine the measurement tools, and to clarify precisely what they are — and are not — measuring. This report identifies the major issues such analysis should address so that it is effective in developing useful measures of the effects and impact of privatization.

Macroeconomic Comparisons

There is little macroeconomic evidence of the impact of privatization on the level and growth of income or on income distribution. This is because of the small number of transactions and the difficulty of distinguishing effects of privatization from those of economic reform. Although from 1988 to 1993 some 2,700 transactions were recorded (with proceeds of more than \$270 billion), two-thirds of the proceeds were realized in industrial countries. Only a few developing countries did any significant privatization, and activity in Eastern Europe was concentrated in a few countries. The average nontransitional developing country had, by 1994, divested only 3 public enterprises (PEs) per year of the 100 or more that typically constitute the public enterprise sector. The share of PEs in GDP has not decreased significantly anywhere and has increased in some cases, the PE share of employment rose from the 1970s to the 1990s, and financial dependence of PEs on central government budgets actually intensified in developing countries as a group (and in all regions). Only the PE share in investment fell worldwide and significantly over the 1980s. It is difficult to expect to find an observable macroeconomic impact, and it is not surprising that, in this environment, nobody has tried an econometric test for ultimate impacts such as changes in levels and rates of growth of GDP.

Country Studies

Most country studies focus on basic facts about the privatization process and sometimes first-round results (numbers of transactions, proceeds, and proportion of the equity in the state portfolio transferred). Discussion of impacts usually is limited to fiscal effects and sometimes changes in enterprise performance. Significant recent studies include Chile (Hachette and Luders, 1993) and Russia (Boycko, Schleifer and Vishney, 1995).

Chile. Hachette and Luders analyze several dimensions of macroeconomic and sectoral impact to investigate the effects of policy and institutional changes over time. No significant differences were found among public, private, and privatized enterprises under similar sets of rules and regulations. Privatization had little effect in stimulating private savings. Controlling for the exposure of *all* firms to market rules, privatization had no effect on employment beyond a one-time reduction of excess Allende-period manpower. The second privatization wave (1984-1989) had positive (though small) effects on employment. Despite data problems, this eclectic approach clarifies the effects of privatization on fiscal, employment, enterprise performance, and growth. The study did not investigate impacts.

Russia. Boycko et al. distinguish control over productive assets from allocation of profits from these control rights. After considering various approaches to depoliticization of control, they conclude that privatization is the best alternative for achieving efficient ownership. They emphasize the speed and breadth of the Russian voucher privatization program: 14,000 firms employing two-thirds of the industrial labor force in 20 months. Although in medium and large firms insiders ended up controlling the shares, the researchers believed privatization succeeded because of depoliticization and new activist outside shareholders. However, government still controls credit policy, heavy regulatory structures, and tax policy, and local governments have stepped in to ensure social services. The study does not assess impact. This upbeat evaluation contrasts to other observers who see the Russian program as a massive giveaway of state assets to insiders, including a later paper by Boycko and Schleifer (with others, 1995), which backtracks by concluding that the design of Russian privatization put too much hope in the behavioral effects of changed incentives and neglected the need for appropriate skills. Other firm-level studies cannot isolate the impact of privatization from that of other factors.

Other countries. The country literature shows that studies of low-income country privatizations are very rare. Except for Bangladesh, few poor countries have been the subject of analytic and impact-focused studies. An ongoing World Bank-financed study of eight African country privatization experiences was unable to evaluate impact. Studies concentrate on divestiture, not on other interesting and potentially important methods of privatizing: concessions; break-up into a private operating company and a state owner, as practiced in areas of French influence; and contracting out, or peripheral privatization (spinning off of functions from state agencies).

Enterprise-level Effects

Most country studies are based on firm-level case studies. Some studies of individual enterprise behavior may compare individual enterprise performance pre-and post-privatization; others are part of impact studies that look at labor and capital market effects. Most case studies of privatization are focused on process and are too recent to address effects or impact. Despite widespread anecdotal evidence, the number of success stories (or anecdotes of failure) is small and seems to be concentrated in the field of service provision. The reason for the paucity of industrial case studies is unclear. Raw enterprise-level case studies, the basic source of qualitative and quantitative impact information, are sparse. Studies on the question of whether ownership matters subject this very limited case study material to econometric analysis to determine whether there are differences in performance between public and private firms.

Whether ownership structure affects enterprise performance is an empirical matter and is testable; there is a large empirical literature on this question. Despite a theoretical presumption and casual observation that private ownership is more efficient, research results are profoundly divided. Initial conditions, modes of privatization, institutional environments, and particularly the capacity of governments to regulate determine efficiency outcomes. The consensus (if there is one) as measured by numbers of publications and conferences in the past half-decade stresses the primacy of competition over ownership, of deregulation over divestiture. However the debate continues. Galal et al. (1994) attribute the contradictory conclusions to the industries studied: some studies find privatized enterprises superior because they illegitimately compare competitive to monopoly enterprises; others compare reasonably competitive firms to find private enterprises superior; and comparisons of monopoly enterprises get results ~~A~~ all over the lot.®

The book by Galal et al. under the leadership of Leroy Jones is the most innovative attempt to calculate the welfare consequences of privatization, and a paper by Megginson, Nash, and van Raudenborgh (1994) addresses stock market performance of privatized companies. Both teams compare like with like in terms of market structure. Both recognize data constraints and take PE noneconomic objectives into account. Both state their methodology clearly. Galal also constructs counterfactuals, to make more ambitious ~~A~~with-without privatization® comparisons. However, only a fraction of the two samples is from developing countries, none a low-income or transitional economy (both acknowledge this limit).

Megginson et al. find that profitability rises for privatized firms in competitive industries, for partial and fully privatized firms, for control and revenue privatizations, for OECD and developing countries. They find reduced debt ratios and increased dividend payout. Improved performance does not require price increases. Efficiency improved in the use of labor, financial, and technical resources for competitive industries, for full as well as for partial privatizations, for control privatizations, and for OECD countries. For revenue privatizations and for those occurring in developing countries, efficiency improvements were insignificant. Employment increased in two-thirds of the cases and decreased only in two cases, both in the United Kingdom. This evidence runs counter to widespread assumptions about disemployment effects and to the popular idea that efficiency is obtained only by sacrificing noneconomic and political goals.

In almost half the Galal cases, productivity increased from management changes, not layoffs. Relaxing the investment constraint had little effect. Most but not all price increases reflected efficiency rather than exploitation. In 5 of the 12 cases, consumers were worse off ~~€~~ primarily because of price increases ~~€~~ but in 4 cases they gained because of increased investment, which yielded expanded services. Foreign actors gained, but domestic agents gained by even more. Profitability increased in all 12 cases; the state gained in 9 of the 12 cases, reaping dramatic impacts of selling

loss-makers. The counterfactuals lead the authors to conclude that Amany gains associated with divestiture could be achieved through implementation of public sector reform with emphasis on applying market principles to public enterprises.@ On investigation, even on the central issue of whether ownership matters, their answer is ambiguous, and several critics have reacted to this.

Fiscal Effects

Many privatization transactions are a simple exchange of assets between private and public sectors and a shift in government-s flow of revenues and expenditures. Without a foreseeable increase in efficiency of use of the privatized assets, fiscal impacts are likely to be small or even negative. Theoretically, future deficits from loss of PE revenue would be exactly offset if government used sale proceeds to buy other financial assets or to retire equivalent amounts of outstanding debt. If government uses the proceeds to finance a temporary increase in current expenditure or to reduce taxes, the year-of-sale deficit will be smaller, but future deficits will be bigger. Because many PEs are money losers, and, for the most part, have dim future earnings prospects, divestiture is often believed to lead to automatic lightening of fiscal burdens. It is nonetheless important also to recognize that divestiture affects government-s net worth and that how revenues from privatization are spent is a significant factor in assessing fiscal impact.

Efforts to quantify the analytic links running from privatization to PE deficit reduction to GDP growth and greater economic welfare are few and unconvincing. In many countries, especially low-income countries, the biggest absorbers of subsidies are basic public services such as higher education, few of which are candidates for privatization and most of which are difficult to make more efficient. PE deficits are often a substantial part of total budget deficits, and reduction of the latter will tend to have positive macroeconomic effects and hence spur growth. Many studies show that big budget deficits are associated with high inflation rates, which are negatively correlated with GDP growth; the link between PE deficits and overall budget deficits appears in research to be close. In a test, however, improvement occurred in 29 middle-income countries, not in 17 low-income countries: in countries where PEs are least efficient and run the biggest deficits, which in turn make up the biggest share of total deficits, no positive fiscal impacts are observable. This lack of deficit reduction in so many countries may explain why there seem to be few country studies that discuss fiscal effects in detail.

The current literature gives little attention to indirect subsidies such as tax and accounting code advantages, import concessions, cheap credit, or access to foreign exchange at preferential rates. Calculations of PE deficits, whether as net financial transfers or "savings-investment@deficits as in *Bureaucrats in Business* (World

Bank, 1995) neglect indirect subsidies though they are often greater in magnitude than direct subsidies and their economic effects are more pervasive and distortionary. Both country studies and enterprise-level analyses can shed needed light on this phenomenon.

Impact on Labor

Workers in factories facing privatization, and organized labor, whose leaders have gained both power and privileges within medium and large firms owned by the state, are potential opponents to privatization. Countries such as Tunisia have tried experiments in providing jobs specifically for redundant workers in public works projects. Others, such as Zambia, have proposed making available land in rural areas to enable displaced factory workers to return to small-scale farming. There has been no general evaluation of the effectiveness of these policies.

Measuring the impact on labor of the various forms of transition from a state-owned and -directed economy to a free market will be neither easy nor quick. Factors to be considered (some included in studies such as that by Galal et al.) include income levels, acquisition of technical skills within the labor force, labor mobility, and the operation of the safety net. For most countries, it is too soon to arrive at any firm judgment on the real impact that privatization and the transition to a free market will ultimately have on labor. Galal et al. found no loss to labor as a class in the cases studied; in 10 cases (in middle-income countries) the workers gained through post-privatization share appreciation where employees were able to buy stock in the new firm. Workers may also have gained where severance pay was offered or from higher wages resulting from greater managerial efficiency and increased productivity. The Megginson research also shows that employment rises after privatization. In transitional countries in particular, the extent to which the workers have suffered from the loss of ancillary services previously offered by PEs remains unclear. Such services are less likely to be replaced by governments in least-developed countries.

Issues and Conclusions

As a guide to future policy research, the topics most neglected or with the greatest contribution to development impact include:

1. Economic effects and impacts of privatization, to guide donors.
2. Case studies of post-privatization effects on management behavior, enterprise performance, and labor's status.

3. Study of labor impacts and safety net policies.
4. Further research on corporate governance issues to have an immediate impact on policies and programs.
5. Study of feasibility and desirability of introducing mass privatization methods in low-income countries.
6. Privatization studies in low-income countries, now inadequately studied.
7. Validity testing on aggregate privatization databases to develop more reliable basic data for research.
8. Studies on important forms of privatization other than divestiture.
9. Studies of the nature and effectiveness of "concessions" used in France and Francophone Africa.
10. Policy studies analyzing the cost of the status quo designed to develop a constituency for privatization among local elites.
11. Targeted research on infrastructure privatization & particularly networks and the regulatory framework & in middle-income and some low-income countries.
12. Studies of implementation processes and procedures for privatization, to develop a "how to" manual for practitioners.

I. DEFINITIONS AND SCOPE

DEFINITIONS

As USAID readers know, *Aimpact@* is not so straightforward a concept as it might seem. So it's worthwhile to clarify some definitions. All projects/programs have consequences or outcomes. Some of these are the immediate output from the program inputs (e.g., number of enterprises privatized, and hours of training received). Other outcomes occur further downstream. Management changes, new investment flows, productivity increases. Still further downstream are broader outcomes: GDP increases, the rate of economic growth accelerates, income distribution is altered.

In ordinary discourse, and even in many program evaluations, all of these types of consequences or outcomes are called *Aimpacts@*. But that can be confusing. Three types of outcome should be distinguished: (1) *Aresults,*" which are immediate first-round outcomes of a program or project, such as number of privatization transactions concluded ; (2)"effects," which are proximate changes induced by a privatization-related project/program/policy, such as changes in methods of management, investment levels, employment and profitability, and enterprise efficiency; and (3) *A impacts@* as defined by evaluation purists: the way the project/program affects global and long-term objectives such as higher income per head, increased rates of GDP growth, reduced levels of absolute poverty.

In this paper, (as in ordinary language) both *Aeffects@* and *Aimpacts@* are lumped together as impacts. The formal distinction is in any case not so watertight. AA number of important outcomes fall between proximate *Aeffects@* and ultimate *Aimpacts@*. Changes in firm-level efficiency might fall in the middle for example, as might deepening of financial institutions and capital markets. So might institutional strengthening of broader kind, such as better decision-making procedures, reductions in net transfers from government budgets to the public enterprise sector and changes in industrial structures. .

These effects and impacts of privatization are the subject of this paper. We review literature in macroeconomic evaluation of privatization, attempts to assess its impacts on economic growth and/or income distribution. We found no effort to assess privatization impacts on these ultimate impacts. We review one study that tries to estimate the impact of privatization on direct foreign investment. The bulk of existing analyses look at *Aeffects@* (changes in enterprise behaviors and increases in efficiency following privatization. This is the main focus of our analysis here. We give special attention to impacts on labor and on fiscal effects.

We do not consider in this paper the evaluation of *Aresults@* (the first round outcomes such as number of successful transactions, training offered, or organizational and legal changes introduced. Nor do we look at specific inputs and processes (i.e., how well privatization projects/programs have been designed and implemented.¹ Neglect of these dimensions of evaluation does not mean they are unimportant. If design and implementation

of specific programs are poor, results will be inadequate or inappropriate and effects and impacts will be few. This is not a merely academic point. Many past missteps in privatization program design and implementation are observable; bad reform-mongering is in fact a significant reason for the sparsity of privatization successes in many countries.² It is also at this level that reformers\donors have most control over ultimate outcomes. But these dimensions of the privatization question are not within the scope of this paper.

Finally, Privatization covers a wide range of instruments. It includes deregulation to permit free entry (A deconfinement), management contracts, leases, concessions, contracting-out, and full transfer of ownership by classic divestiture. We focus in this study primarily on economic impacts due to privatization of ownership.

CAVEATS

Several fundamental obstacles, which bedevil all impact assessments, operate very strongly in the privatization case. The first is the so-called Attribution problem. In transition economies particularly, but in most developing country situations as well, privatization usually occurs as part of a broad stabilization/liberalization program. Separating

¹ Inputs and processes are the main substance of conventional project/program evaluation. These address such questions as: were program objectives well conceived and clearly defined? Was the design appropriate? Did the program deliver what it was supposed to – so many person-months of technical assistance, so much training, so much brick and mortar, etc.? Did it do so in a timely way, with good quality people? Were training components big enough and implemented well, and did assistance unfold in a collaborative, capacity-enhancing manner? In a privatization project, were company evaluations done appropriately, were marketing efforts energetic?

² Among the many shortcomings are: creation of privatization agencies that are too dispersed in structure, which discourages specialization of staff; giving too much emphasis to asset evaluation and too little to marketing; failing to educate politicians that the only true measure of a firm's value is what somebody is willing to pay for it; neglect of non-divestiture options; failure to address in pre-transaction operations the real intellectual and political hesitations about divestiture – for example loss of cross-subsidies, fear of deindustrialization, fear that crooked deals will dominate whatever is said about transparency. Also, local capacity building has been too often neglected in donor-assisted programs in low income countries. See Elliot Berg et al. A Privatization and Development Project; Midterm Evaluation Report for USAID, DAI, September 1994.

out the effects of privatization from those due to other changes in the macroeconomic environment is extremely difficult, to say the least.

The second basic problem is the reliability and availability of data. Privatization is a recent occurrence in most parts of the world. So experience is still limited in time. When Galal, Jones, Tandoon, and Vogetsang surveyed the world for case studies to include in their path-breaking study, *Welfare Consequences of Selling Public Enterprises*, they found their range of choice extremely limited. This is why their study includes only more advanced developing countries (Mexico, Chile, Malaysia) and an industrialized country (the United Kingdom). The sparse data available in the low and lower middle income countries & the great bulk of the developing world & severely limits sampling possibilities in all studies.

A third problem concerns insider privatization and partial sales, neither of which may change the efficiency with which publicly-owned assets are managed after privatization. It would be wrong to impute economic impacts (or their absence) to privatization in these cases, without investigating whether ownership transfer has changed managerial behavior.

Finally, there is the need to take account of objectives other than increased efficiency and faster economic growth. In many privatization programs simple reduction of the size of government is a key goal. In others, the broadening of share ownership is a major objective. In many, a major purpose is to send signals to investors and donors that policy environments have changed. These Apolitical@ and intangible goals have been present in most countries= privatization experience. Indeed, when trade-offs are necessary during the evolution of privatization programs & as they inevitably are & it is most often the goal of increased efficiency that is sacrificed.³ So Asuccess@ of such programs cannot be judged solely in terms of short- or medium-term economic impacts. In the long run of course, it would be hard to accept as Asuccessful@ any program that did not increase efficiency and growth and/or reduce poverty.

SCOPE

The body of the report describes and assesses existing approaches to evaluating economic effects of privatization. The report reviews much of what is known about these economic effects. Chapters Two and Three comment on the extremely limited macroeconomic evaluation that has been done & that is, attempts to measure privatization-s impact on income, growth, and income distribution. Chapter Four surveys several country studies. Chapter Five & the longest & looks at enterprise-level effects; this is where the bulk of existing research has

³ This is the conclusion of Adam-s study of seven developing countries. **Christopher Adam et al., 1992, *Adjusting Privatization: Case Studies from Developing Countries*, London, pp.52 ff.**

focused. Chapter Six addresses fiscal impacts, and Seven labor impacts. Chapter Eight sets out the implications of this review for future research needs.

Annexes A, B, and C focus on problems with measuring the extent of privatization, on political economy, and on regulatory system issues. These annexes are from an earlier version of this report, the scope of which was refined in an iterative process of dialogue between USAID and the contractor.

Annex D is a selective bibliography. It summarizes an intensive search of recent writing on privatization. This literature has become so voluminous and so dispersed that researchers and practitioners are no longer able to keep track of it. This bibliography is intended to help. It covers a very broad range of sources, focusing on findings of the last three years.

The report is intended to provide background for future program evaluation. It also indicates some priorities for future research on the economic impacts of privatization. Some of the analysis may be useful in the definition of appropriate performance indicators for privatization programs.

II. IMPACTS ON LEVELS AND GROWTH RATES OF INCOME AND ON INCOME DISTRIBUTION

We could find no country study using time series analysis to estimate the impact of privatization programs on national GDP, rates of growth of GDP, or income distribution. Nor did we locate any multi-country cross section analyses that try to measure these impacts by formal regression analysis.

One obvious reason is the recency and limited reach of the privatization phenomenon. Up to 1987, only some 700 divestiture transactions could be identified worldwide, 500 of them in developing countries.⁴ Most of these were small; African sales during those years were half the total for developing countries, and their proceeds totaled only a few hundred million dollars.

Up to the late 1980s, and indeed into the early 1990s, most privatizing took place in the industrial countries, which accounted for more than three-quarters of total proceeds. Only a few developing countries did any significant privatization – Chile, Bangladesh, Guinea, Malaysia, Jamaica for example. Even in Eastern Europe, most privatization activity was concentrated in a few countries – the Czech Republic, Hungary, East Germany.

Between 1988 and 1993 some 2700 transactions have been recorded, with proceeds estimated to be over \$270 billion. But two-thirds of the proceeds were realized in industrial countries, and much of the rest in a relatively few developing countries. On average, developing countries have done little privatizing, and low income countries very little. As has frequently been noted, developing countries, excluding the transition economies, had by 1994 divested average only three public enterprises per year from among the hundred or more that typically constitute their public enterprise sectors.

Recent World Bank-financed research (still in process) has identified 1,900 privatization transactions in Africa since 1980, for a value of \$US 1.9 billion. But almost half the number took place in four countries with more than 100 sales – Angola, Ghana, Kenya and Mozambique. In terms of value of sales, over 50% occurred in two countries (Ghana and South Africa) and almost all of it in eight countries with over \$50 mn. in total sales proceeds (Ghana, S. Africa, Mozambique, Uganda, Tanzania, Guinea, Senegal and Nigeria). Such small totals cannot be expected to have had observable macroeconomic impacts.

⁴ The sources for these numbers are **World Bank, 1995, *Bureaucrats in Business. The economics and Politics of Government Ownership.*** Policy Research Report, Oxford University Press, and **Frank Sader 1995, @Privatizing Public Enterprises and Foreign Investment in Developing Countries, 1988-93,@International Finance Corporation.**

Text Table I (Changes in Economic Weight of PE Sectors) shows that public enterprise sectors (PES) have shrunk extremely little on average in developing countries in the past 15 years, despite the hundreds of privatizations that have taken place. The share of PES in GDP (and non-agricultural GDP) have not decreased significantly anywhere and have increased in some cases. The public enterprises employed greater shares of the labor force in the early 1990s than they had in the late 1970s. Financial dependence of PEs on central government budgets actually intensified in developing countries as a group and in each regional subgroup. The only measure that shows reduced PE presence is share in investment; the PEs share fell everywhere, and significantly, over the 1980s.

TABLE I
CHANGES IN ECONOMIC WEIGHT OF PE SECTORS, 1978-80 TO 1990-1991
(Unweighted Averages)

| | 1978-80 | 1990-91 |
|---|---------|---------|
| PE Share in GDP (%) | | |
| All Developing Economies(40) | 11.1 | 11.1 |
| Low Income(15) | 14.3 | 14.1 |
| Middle Income(25) | 08.1 | 09.3 |
| Africa(14) | 13.9 | 13.8 |
| PE Share in Non-Agric.GDP | | |
| All Developing Economies (40) | 12.0 | 13.6 |
| Low Income (15) | 18.8 | 18.6 |
| Middle Income (25) | 09.4 | 10.6 |
| Africa (14) | 17.3 | 16.8 |
| PE Share in Gross Domestic Investment | | |
| All Developing Economies (55) | 22.5 | 18.6 |
| Low Income (18) | 30.8 | 25.1 |
| Middle Income(37) | 26.9 | 15.5 |
| Africa (15) | 30.5 | 23.6 |
| PE Share in Employment | | |
| All Developing Economies (21) | 10.2 | 10.9 |
| Low Income (10) | 15.0 | 16.3 |
| Middle Income (11) | 05.3 | 06.0 |
| Africa (9) | 19.3 | 22.1 |
| Net Financial Flows to PE Sector as Share of GDP | | |
| All Developing Economies (37) | 0.2 | -1.3 |

| | | |
|--------------------|-----|------|
| Low Income(12) | 1.5 | 0.1 |
| Middle Income(25) | 0.4 | -1.9 |
| Africa (12) | 1.1 | 0.1 |

Source: World Bank, *Bureaucrats in Business. The Economics and Politics of Government Ownership*, (1995). Statistical Tables.

Given the limited effects of privatization programs in changing macroeconomic indicators, and the recency and geographically concentrated character of such privatization as has occurred, it is not surprising that nobody has tried to test econometrically for ultimate impacts such as changes in levels and rates of growth of GDP. These factors compound the difficulties that already exist on other grounds, notably the weakness of data and the intractability of the attribution problem. After all, privatization, even where it occurs on a significant scale, is almost always part of general transformation/liberalization changes, and it is extremely difficult to credibly disentangle the macroeconomic impact of privatization from the broad reform program of which it is so often a part. Exercises that try to estimate the relative weight of the different components of reform in explaining macroeconomic changes are unlikely to yield convincing numbers. It's not surprising that the most ambitious effort yet undertaken to measure impacts of privatization made no effort to disentangle privatization impacts from those of other macroeconomic reforms.⁵

FURTHER RESEARCH

Additional research efforts should be focused to produce econometric studies on the levels and growth rates of income, on income distribution, as well as on GDP growth. This may involve developing and adopting new methodologies, soliciting support from host government statistics bureaus, and prolonged donor organization efforts. These research efforts should also include developing the use of time series analysis and regression analysis methods as the amount of time since privatization efforts began increases.

⁵ Galal, Jones, et.al, 1994.

III. OTHER MACROECONOMIC APPROACHES

One recent study has estimated the impact of privatization programs on foreign direct investment (FDI). Frank Sader⁶ of the IFC adapts a model developed by Sebastian Edwards for the purpose of estimating determinants of FDI from cross-section data for 58 developing countries during 1971-81.⁷ On the basis of the literature, Edwards selected a set of structural variables believed to affect foreign investors' decisions: return on capital, openness, the investment climate, the size of government and international competitiveness of the country.

Sader used these same independent variables and re-estimated the model for a cross-section of 36 countries for the years 1988-1993. The countries were selected because they had data and, according to the author, also had sizeable privatization programs during the period 1988-1993. The results were similar to those found by Edwards. Sader's R square is .65, while Edwards' was .52. But the significance of some of the independent variables was very different. For example, the international competitiveness measure is much less important in Sader's re-estimation than in Edwards' paper.

Sader then introduces a privatization variable, privatization revenues per capita, in order to estimate the impact of the size of privatization programs on foreign investment decisions. His results indicate that privatization was an important element in the foreign investment decision. The coefficient (between size of privatization program and FDI) is positive, large, highly significant statistically and extremely robust. He states: "While such results always have to be interpreted rather carefully, the coefficient indicates that each dollar in privatization investment generated an additional 88 cents in new investment independently of the actual privatization transaction."

Sader pushes the analysis a step further by replacing the general privatization variable with sector specific privatization revenue variables. Privatization in primary sectors and finance appears to have no significant impact on FDI. He therefore rejects the argument that signaling effects led to increased FDI. However, strong and significant results follow from privatization in industrial and infrastructure sectors. Sader asserts that the industrial privatization-FDI relationship is probably accounted for by the direct effect of the privatizations. But he attributes much greater FDI-inducing effects to infrastructure privatizations, arguing that they reduce costs and assure potential new investors about

⁶ Sader, Frank, 1994, *Privatization Techniques and Foreign Investment In Developing Countries, 1988-93*, International Finance Corporation, Washington, D.C., pp. 26-33.

⁷ Sebastian Edwards, 1990, "Capital Flows, Foreign Direct Investment and Debt-Equity Swaps in Developing Countries," National Bureau of Economic Research Working Paper No. 3497, Cambridge, Mass.

profitability prospects. Sader concludes: "investors base their decision about whether to make their investments abroad on the state of the existing infrastructure."

Three sets of questions are in order. The first has to do with the suitability of the variables chosen in the model. The measure of the extent of privatization (privatization revenues per capita) attributes more privatizing to little than to big countries. It's not intuitively clear that the privatization of a few SOEs in a small country, which yields high proceeds per person, should encourage FDI flows more than many transactions in a big country.

Moreover, the measure used to indicate return to capital (per capita income) is not a credible proxy. It assumes that low income countries have low labor costs and that the level of labor cost is a main determinant of FDI. Both assumptions require scrutiny. Indeed, both Edwards and Sader admit as much. Similarly, the openness measure (total trade to GDP) has been widely rejected in other studies, because it is a misleading indicator. The real exchange rate measures, proxies for competitiveness, came from different sources in the two analyses, and gave inconsistent results.

The second issue is the reliability of the data used. The key variable used by Sader, the size of privatization proceeds per capita, is extremely weak. Proceeds in most low income countries are usually the total agreed price; actual receipts paid into the treasury are often a small fraction of that amount. Sader's estimates of privatization revenues in Sub-Saharan Africa for example, have been recalculated on the basis of more recent studies. The new studies estimate proceeds at \$1.6 billion., a third less than the \$2.4 billion. Figure given in the Sader paper and half the amount given in the most intensive (and quite recent (1995) study, *Bureaucrats in Business*. Margins of error of this size have to give pause as to the credibility of the findings.

Moreover, Sader says that he picked countries with A sizeable@ privatization programs. But among those included are: Cote d'Ivoire, Egypt, Ghana, Indonesia, Kenya, Turkey and Zambia (all of which we know from other sources have done extremely little privatizing before 1993. No country data are given in the paper, so the figures can't be checked. But since so many of those selected are well-known laggards in privatization, one has to wonder about the solidity of the basic numbers.

Finally, there's much that's implausible in the analysis. It's reasonable enough to argue that countries doing comparatively more privatizing are likely to be relatively attractive to foreign investors. But there is the question of lags. Sader pools his data for 1988-1993. But most of the privatizations occurred late in the period. Since it takes time even for the roughest information about privatization programs to reach investor ears, and much more time for investor money to be unloosed, reasons for the high correlations need better elaboration.

Even more important, Sader pays much too little attention to the attribution problem. As noted above, privatization programs are almost always embedded in broader macroeconomic reform programs. Where this is not true, foreign investors are unlikely to come. Where it is true, the impact on investment climate of the overall reform program is likely to be much more significant than the privatization element alone.

All of this creates considerable doubt about the meaningfulness of the findings of this study, and indeed of the potential of this approach for measuring the impact of privatization on FDI or on other macroeconomic aggregates. The same skepticism must greet the intriguing argument about the key role of infrastructure privatization & that it induces FDI because it signals a future of lower costs and increased profitability. This is imaginative and may even be true. But the general literature on determinants of FDI does not give great weight to this factor. In light of the crudeness of the model and the analytic and empirical doubts that its results inspire, this conclusion about the effects of infrastructure privatization is not convincing.

FURTHER RESEARCH

The relationship of infrastructure and FDI is an important one, worthy of continued and improved study. A priority area should be in defining the determinants of FDI. For example, the Sader study could be replicated, but with better data on privatization proceeds and with better country selection, investigating countries which have truly been active in privatization efforts. More emphasis should be placed on assessing the impacts which are only realized in the longer run, and on finding ways to isolate privatization's effects from other economic trends.

IV. COUNTRY STUDIES

Numerous country studies on of privatization can be found in recent literature. Among the many examples are the Hachette and Luders study of Chile, Adam and colleagues's seven country studies, and Boycko, Schleifer and Vishny's book on Russia.⁸ However, most of the existing studies have little to say about economic impact. They are mainly focused on the process and on putting together the basic facts & what was privatized, for how much, by what modality, how and to whom. They have something on first-round consequences & results (in terms of numbers of transactions, and proceeds, and proportion of the equity in the state portfolio transferred to private ownership). But discussion of impacts usually is limited to fiscal effects (changes in net financial transfers between budget and the state enterprise sector), and & much less thoroughly & to changes in enterprise performance. We analyze below several of the studies that do most to analyze economic effects.

⁸ **Dominique Hachette and Rolf Luders, 1993, *Privatization in Chile. An Economic Appraisal*.** International Center for Economic Growth, San Francisco; **Christopher Adam et al., 1992; Maxim Boycko, Andrei Schleifer and Robert Vishny, 1995, *Privatizing Russia*,** M.I.T. Press.

CHILE

The Hachette and Luders study is among the few that make analysis of impacts a major theme. They describe the many dimensions of Chile's privatization: agricultural land, pension funds, health care, education and housing, as well as mining, industry, commercial and service sectors. They analyze fiscal impacts intensively and discuss the effects of privatization on the capital market, ownership distribution, savings and investment and employment. They use straightforward economic analysis, without recourse to econometric inquiry.

Among their interesting conclusions: privatization had little effect in stimulating private savings, and it did not have negative effects on employment. There was some wringing out of excess manpower in public enterprises, most of which originated from an Allende effect—the fattening of payrolls during 1970-1973. But employment between 1973 and 1989 fluctuated according to the level of activity. Analysis of employment levels in ten privatized firms shows declines during the first wave of privatization (1973-83), then increases during the second wave (from 1984 to 1989). The authors conclude that changes in employment were unrelated to the privatization process per se. What affected employment was the exposure of all firms to market rules. During the second privatization wave (1984-89), effects on employment were apparently positive, though small.

Serious analysis was made of the question: whether privatized enterprises have behaved differently (more efficiently) than others. Two approaches were adopted. First, a large number of financial ratios were calculated for six groups of firms—82 that had always been in the private sector; and smaller numbers of reprivatized firms, privatized firms, and some that were still in the public sector. Discriminant and canonical analysis was used to determine whether the groupings made statistical sense and which ratio variables best explained differences among the groups. In addition, simple historical comparisons were made of the evolution of selected ratios between 1965 and 1989. This allowed investigation of the effects of policy and institutional changes over time.

No significant differences were found among public, private and privatized enterprises under similar sets of rules and regulations. Private sector firms were more profitable than State Owned Enterprises (SOEs), but differences, though statistically significant, were very small. The authors regard these results as failing to confirm theoretical expectations about the greater efficiency of privately owned enterprises.

There are numerous weaknesses in these results, most of them acknowledged by the authors. Data limitations imposed small samples. Use of financial ratios says little directly about allocative efficiency. Even where differences in profitability or investment behavior are found, this can represent not efficiency differences, but simply the results of public service obligations imposed on the SOE.

Nonetheless, this eclectic approach, which uses economic analysis at various levels, is certainly useful in clarifying the economic effects of privatization. It should be noted,

of course, that the analysis is restricted to A effects@ C fiscal, employment, enterprise performance C and does not discuss ultimate impacts, on income levels and growth rates, for example.

RUSSIA

The Boycko, Schlerfer, Vishmy book (Privatization Russia, MIT Press, 1995), by three participants in Russia's privatization, is part theory, part history and part assessment of results. A strong flavor of practical experience runs through the book. Combined with a lively prose and technical sureness, it makes this an unusually rewarding read.

The theoretical framework develops the distinction between two kinds of ownership rights C those that concern control over productive assets and those that concern allocation of profits from these control rights between different agents. The authors argue that control by politicians over assets is an extremely inefficient form of organization, and is at the heart of the privatization question. They consider various approaches to depoliticization and conclude that privatization is the best alternative for achieving efficient ownership.

The second part of the book describes the Russian privatization program. The practitioners' perspective is evident throughout. The constraints and opportunities before the reformers are nicely described, and the reasons for strategic choices explained.

Boycko and his colleagues have one chapter on results. They emphasize that the Russian voucher privatization program is unmatched for speed and breadth. In 20 months, 14,000 firms employing two-thirds of the industrial labor force had been privatized by voucher auctions. Since 1992, tens of thousands of smaller firms were privatized by auction, lease, or employee buy out. It is true that medium and large companies had been taken over mainly by insiders. In one study sample of 143 such companies, managers and workers together ended up owning an average of 65% of the shares. (Almost 9% was held by the top management team.) Outsiders owned about 20% and government 15%.

Despite insider dominance, the authors argue that the privatization has been successful, according to the two criteria they believe primordial. First, massive depoliticization has taken place. Control rights have been transferred from government ministries to managers and investors. The sectoral ministries, only a few years ago the kingpins in Russian industry, have become irrelevant. The process of depoliticization is incomplete, since government still has many levers of influence (credit policy, heavy regulatory structures, tax policy), and local governments have stepped into the control system out of interest in social services. But depoliticization has come a long way.

Secondly, Russia has made a giant step toward efficient ownership patterns: outsiders have been accumulating shares in the voucher and share markets. Various indications of large shareholder activism can be seen; one example they ate occurred: in three large cities, for example, where 10% of the general directors were removed at initial

stockholders= meeting.

This study contains little in the way of assessment of downstream economic effects or impacts. The authors point out that privatized firms are restructuring. One study found that over 60% of industrial firms were making product changes, taking new marketing steps, changing suppliers and reducing their work force. Some showcase restructurings are cited. The St. Petersburg optical manufacturer LOMO hired McKinsey consultants to reorganize, changed its product mix, reduced the labor force by a third and created its first sales force. Several joint ventures with foreign investors have been initiated. Similarly, URALMASH, a Siberian heavy machinery producer, cut its work force from 70,000 to 20,000 and signed several joint ventures. But such radical restructurings are rare.

Other economic effects are said to have occurred. The authors cite estimates that indicate the Russian economy generated \$US 20 billion. of new savings available for investment in the first half of 1994. The Russian capital market has made big strides. Securities trading has become "significant." And private capital is already beginning to erode the politicization of capital allocation.

The authors acknowledge that privatization is unfinished business in Russia. They point to the failure to privatize urban land and real estate and to continuing political control via an extensive regulatory system and local government interventions. But their overall assessment is strongly positive.

This upbeat evaluation is in sharp contrast to the many negative appreciations by

⁹ A strongly negative assessment is given in **Lynn D. Nelson, 1994, "An Assessment of the Russian Privatization Program,"** paper prepared for the Committee on Small Business, U.S. House of Representatives, April 14, 1994. He cites poll data to show that the voucher privatization program is (or was in 1993) extremely unpopular. Only 5% of enterprise directors in his study favored voucher privatization as it had been organized. Most would have preferred sale at more realistic prices, since they cited lack of money as their major constraint. He found that the process did nothing for enterprise restructuring: most management teams stayed on, workers kept their jobs. The program has not only failed to dynamize Russian industry, it has been highly inequitable, benefitting a few insiders and, according to popular views, the so-called Mafia.

Negative views also are frequently reported in the international press. A recent newspaper report says that many Russians blame privatization for the nation's woes. They are asking the question: who got what and why? The new head of the GKI (State Property Committee) told the reporter: **If you stopped 10 people in the street and asked them about their problems, nine would tell you that privatization is at fault.** The

outside observers, many of whom see the Russian program as a massive giveaway of state assets to insiders.⁹ Differences are to be expected. In part this is inevitable because the method of evaluation is highly qualitative. Also, the experience is new and the program is still evolving. Good studies are few and most focus on corporate governance issues rather than on effects or impacts. Given the uncertain link between insider privatization and changed management behaviors, this priority is justifiable.

It's interesting to note that a later paper by Boycko and Schleifer (with others), backtracks considerably from the very positive conclusions in *Privatizing Russia*.¹⁰ This paper admits that the design of Russian privatization put too much hope in the behavioral effects of changed incentives and did not sufficiently recognize that in labor markets changed skills often matter more than changed incentives if managers are to be more effective in achieving production efficiencies.

The principal message we draw from our empirical evidence is that restructuring requires new people, who have new skills more suitable to a market economy. A secondary message is that, without new people, incentives for old people might not be particularly effective in bringing about significant change. Continued control by old managers presents a problem for restructuring, and...more attention should have been paid to management turnover as opposed to shareholder oversight over the existing managers. To some extent, large investors have begun to force old managers out and old managers have been given enough wealth that they can afford to retire in peace and let a new generation take over. This, however, is probably not enough. If privatization were designed from scratch, these strategies should have received more attention than they have.

With respect to privatization's impact, in any event, it is too difficult to determine the relationship between ownership change and enterprise behavior in Russia at present, and this is undoubtedly true for all transition economies. A study aimed at determining post-privatization changes in Russia provides a nice example.¹¹ Managers of a carefully-selected sample of 92 firms in Moscow and Vladimir Oblasts were asked in November 1993 what changes they had made in the past 12 months. All were recently privatized. The

loans for shares program initiated in 1995 did much damage; it was seen as involving many rigged deals, benefitting insiders. The new GKI head has publicly criticized what he called the unjustifiably fast tempo and ill-conceived schemes of the privatization program, and is calling for repossession of unlawfully auctioned SOEs, where taxes are owed. (*Wall Street Journal*, March 19, 1996.)

¹⁰ **Nicholas Barberis, Maxim Boycko, Andrei Schleifer and Natalia Tsukanova, 1995, "How Does Privatization Work? Evidence from the Russian Shops,"** 2nd draft.

¹¹ **Lila Webster et al., 1994, "Newly Privatized Russian Enterprises,"** World Bank Technical Paper No. 241.

changes mentioned included the following: most ownership had been fully transferred; 55 of the 92 firms had laid off workers, on average 10% of their workforce; 14 had hired new employees, on average 8% of their workforce; 47% had changed their product mixes; 77% had taken short term loans; 57% stated they had changed how they reward workers, trying to link performance and pay; and 45% had made investments in other firms.

However, it proved impossible to determine how much of this was due to privatization and how much to other factors. Indeed, as the authors note in their conclusion:

Entrepreneurs were asked to identify changes that had taken place in their firms since privatization. Many managers spontaneously revised this question by saying that recent changes in their firms had resulted more from the economic crisis in Russia – most notably the recession that is underway – than from the shift in ownership.

The Chile and Russia studies were chosen for consideration here because they represent countries with extensive privatization experience, and because they are focused on economic effects/impacts to a greater degree than is common in the literature. Several conclusions emerge from these analyses. First, with respect to labor impacts. In the Chilean case, labor impacts that can be attributed directly to privatization seem small, once the Allende (job inflation) effect is removed. During the far-reaching second wave of privatization, employment changes were more a function of the level of economic activity than of ownership changes. This is consistent with some of the firm-level studies to be reviewed below. But it is at variance with expectations and some experience in the low income countries, where overmanning is particularly rife.

Second, even in the analytically refined Chile study, effects on efficiency, capital market development, income growth and other developmental impacts proved hard to determine and harder to attribute to privatization as such. Fiscal impacts are shown to depend on how privatization-induced budget savings are used. In principal, significant fiscal effects follow privatization only if management of privatized assets is more efficient as a result.

Finally, the search through the country study literature confirms the casual impression that studies of low-income country privatizations are very rare. Except for Bangladesh, very few of these poor countries have been the subject of analytic and impact-focused studies. A World Bank-financed study of 8 African country privatization experiences should be available by the Summer of 1996. But even these studies were apparently unable to do much on evaluating impacts; they found the data so bad that cleaning up the numbers proved to be an absorbing task.

It is also worth noting that country studies, like the enterprise-level studies to be discussed below, concentrate on classic divestiture – the sale or liquidation of state-owned companies. They usually say little about the other instruments of privatization. Particularly interesting and potentially important methods of privatizing are neglected in these country-based studies. Little of any depth has been written about concessions, for example, which are of great and growing importance. In the Francophone parts of the developing world there is

widespread resort to the device of creating two companies, a privately-owned operating company (*A Société d'Exploitation*) and a state company that owns the assets (*A Société de Patrimoine*), Nor is there much on contracting out and *A peripheral privatization* the spinning off of functions from state agencies.

FURTHER RESEARCH

There is the need for country studies which systematically assess the extent and impact of privatization programs. This will not only assure thorough research, but assist in comparing various country analyses. These studies should increase emphasis on impacts, in addition to the current tendency to focus solely on process and the political environment. Impacts should be defined to include growth rates, income levels, fiscal and enterprise impacts. Where possible, researchers should return to sites of earlier studies and analyze the long term impacts and their consequences.

V. ENTERPRISE-LEVEL EFFECTS

Approaches/studies cannot be compartmentalized as country studies or analysis of enterprise level effects. The Hachette-Luders study of Chile is based on the study of individual privatized enterprises. But country studies involve much more, as a concept and in reality. It can include a descriptive analysis of the national privatization program's design and implementation. It can entail comparative studies, not only of firm performance before and after, but comparison with firms having different ownership structures. It can analyze overall fiscal impacts, labor market effects, or credit and capital market consequences of the whole array of privatizations.

Firm-level approaches restrict themselves to case studies of individual enterprise behavior. They come in various forms. Some are simple case studies, comparisons of individual enterprise performance pre-and post-privatization. These usually come in anecdotal form. Quite often they are inserted as "boxes" in larger studies. Or they may be part of more extensive impact studies, that look at labor and capital market effects. Usually, however, these extensions are quite casual, unstructured analytically. And anyway, most case studies of privatization still are focused on process, and since they are recent, little is said about effects and of course even less about ultimate impacts.

Second, there is a large literature & in fact the bulk of the empirical literature on the question of whether ownership matters & that is based on case study material, and subjects it to econometric analysis to determine whether there are differences in performance between public and private firms.

Finally, there are several recent studies which have had much influence & the book by Galal et al. *Welfare consequences of privatization*, and a paper by Megginson, Nash and van Raudenborgh (1994) on stock market performance of privatized companies. The Galal et al. study is based on case studies, but pushes the analysis in many new directions. The Megginson, W., R. Nash, and M. van Raudenborgh, "The Financial and Operating Performance of Newly-Privatized Firms: An International Empirical Analysis," the Journal of Finance, June 1994. Paper uses the enterprise as the unit of analysis, but does extensive comparative analysis.

We consider each of these types of approach in turn.

FIRM-LEVEL APPROACHES

These are found mainly in the pages of donor agency reports. Here are a few examples.

!

Privatization by tender of much of the Argentine rail system has resulted in a reduction in the railroads' drain

on the government budget from \$US 1 billion in 1987 to \$150 million in 1993. Staff in one segment fell from 3,000 to 780 for the same freight volume, and the increase in rail efficiency stimulated the trucking industry to cut rates by 20-30%.¹²

! By the mid-1980's the water supply system of Conakry, Guinea was nearly non-operational. Water flowed irregularly, and in low volume. Bacterial levels were at unacceptable levels. Much of the growing urban population was without access, except via public pipestands. The budget of the water authority was minimal. By the late 1980s only 5% of private consumers paid their bills. In 1989 operation was turned over to a private company. Remarkable improvements followed. Water production doubled between 1990 and 1995, and was completely potable by 1992. The percentage of production reaching billed consumers rose from 39% in 1993 to 53% in 1995, and the percentage of bills paid rose from 5% at the outset to 72% in 1995. All this was accomplished with minimal social disturbance. The majority of the almost 300 redundant employees were encouraged to form cooperatives to work as subcontractors to the private water company, for new branching, maintenance of canals and related materiel and similar activities.¹³

! In January 1988 the Chilean government sold nearly 50% of its telephone company, CTC, to an international investor. A large investment program was undertaken: line capacity grew at 23% a year, faster than any other country. Efficiency increased: the number of employees per 1,000 lines fell from 13.7 in 1989 to 6.2 in mid-1994.¹⁴

! ADeconfinement," which is privatization by deregulation, knocking down barriers to entry, is a major source of

¹² **David Donaldson, 1995, *Privatization Principles and Practices*, International Finance Corporation, p. 43.**

¹³ **Elliot Berg, 1995, *Plan of Action for Privatization in Guinea*, Report prepared for the Government of Guinea.**

¹⁴ **Donaldson, David and Dileep Wagl, 1995, *Privatization: Principles and Practice*, International Finance Corporation Lessons of Experience Series, Washington, D.C.**

efficiency gains. In many Latin American ports, traditional practice was for a small group of unions to charge high prices for stevedore and other services, and to subcontract the work to others for a fraction of that price. Mexico began to deregulate in 1991, allowing freer competition in the ports. Spectacular effects followed: costs of services declined by 30% according to one study.¹⁵

Other such stories exist. But the number of even moderately well developed success stories (or indeed anecdotes of failure) is surprisingly small. Moreover, most of those that are at hand seem to refer to service provision. It is worth noting that even the analytically sophisticated study, Galal et al. has no industrial enterprise in its 12 case studies, though there is one electricity generating company. Whether the paucity of industrial case studies has some special significance is not clear. In any event, it is quite extraordinary that raw enterprise-level case studies, the basic source of impact information both qualitative and quantitative, are so sparse.

RELATIVE PERFORMANCE OF PUBLIC AND PRIVATE ENTERPRISES

Theory

Neo-classical economic theory says little about ownership as a determinant of enterprise behavior. What matters is market structure. Modern agency theory addresses the ownership issue directly, and most writing on relative efficiency has its roots in this branch of theory, along with renovated classical ideas, notably with respect to the contestability of markets, and x-efficiency.

The efficiency rationale for privatization, in any case, rests on five pillars. First, managers will perform better under private ownership. This partly because there is a market for their services and remuneration will tend to be more closely related to competence and performance than is likely in public sector bureaucracies. Also, concern with outcomes will outweigh preoccupation with procedures; decision-making is less ponderous and agile market behavior more likely.

Second, public enterprises have soft budget constraints, while private firms have to face capital market pressures which push them toward greater efficiency. Third, exit is easier under private ownership. Fourth, and perhaps most important, it is harder for politicians

¹⁵ **Arturo Fernandez, 1995, "Deregulation as a Source of Growth in Mexico,"** paper cited in S. Edwards, *Crisis and Reform in Latin America*, World Bank, pp.193-4.

to intervene in private decisions. And finally, profit-seeking boards of directors make for more economically-oriented governance of corporate assets.

While it is possible to have all of these efficiency pillars under public ownership, in fact there exist relatively few instances where this occurs, and even fewer where it occurs over a long period of time. Probably the most persuasive element in the rationale for privatization is the observed difficulty in reforming SOEs and in keeping them reformed.¹⁶

The issue of whether ownership structure affects enterprise performance is an empirical matter in any case, and is presumably testable. There is indeed a very large empirical literature on this question. The trouble is that despite theoretical presumptions that private ownership is more efficient, and apparent confirmation given to this presumption by casual observation, the results in the existing body of research are profoundly divided, and skepticism persists that ownership matters or at least that it matters much. Initial conditions, modes of privatization, institutional environments and particularly the capacity of governments to regulate, whether by administrative means or by creating competitive markets these are widely believed to determine efficiency outcomes. Ownership transformation by itself may achieve little.

Prevailing Views: Competition Matters Most

The empirical literature has always been divided on the question of relative efficiency of public and private enterprises. Until very recently, the balance of intellectual opinion has supported the position that ownership matters much less than market structure; it is competition that induces efficient behaviors.

We review below some of the literature on the question of whether ownership matters. It is not easy to discern consensus. But the views expressed in some strategic publications can be taken as barometers of the opinion of informed and interested publics. The 1989 Special Issue on Privatization of the *Journal World Development*, is one such barometer. Virtually all of the contributors to that collection stress the primacy of competition relative to ownership.

Another illuminating source is the report of a United Nations Expert Group Meeting on privatization held in late 1992. This document provides insight into typical views as of that time. The report devotes three-quarters of its space to constraints on privatization, and the remainder, devoted to impacts, is characterized by a generally skeptical attitude

¹⁶ See **John Nellis and Mary Shirley, 1991**, *Public Enterprise Reform. Lessons of Experience*. Economic Development Institute, World Bank, Washington, D.C.

¹⁷ **United Nations Development Programme, 1992**, Division for Global and Interregional Programmes, Interregional Network on Privatization, *Report of the Expert*

toward efficiency impacts of private ownership. Privatization failures, of which there are of course many, receive at least as much attention as successes. Few numbers are presented.¹⁷

The report notes, first, that the most commonly-used indicator of efficiency impacts is profitability. But this is a flawed indicator to the extent that privatized enterprises retain market power. Where there are cost savings and other signals of efficiency gain, the question raised by many workshop participants was whether these came necessarily from divestiture. To the extent that they came from competition, there may have been no need to privatize, but simply to deregulate.

The country studies prepared for the workshop (as summarized in the report) were generally negative on efficiency gains from privatization. The paper by George Yarrow emphasized that increased productivity and profits in the U.K. since privatization is true of both private and public sectors. Polish enterprise experience was described as Amixed® after privatization, with as many companies in worse situations as in better ones. The gains in Guyana are downplayed.¹⁸ Nothing good was said about the Argentine telecommunications (ENTEL) privatization. Tariffs were said to have more than doubled, cross-subsidies were endemic, service deteriorated and no effective regulatory authority was created. Argentine Airlines saw decline in quality of service and safety standards. The Bangladeshi country report observes that privatization has made little impact on foreign private investment, and another participant asserted that no efficiency gains were observable in the divested cotton textile companies.

THE ACADEMIC LITERATURE

While the academic literature also lacks consensus on the ownership issue, it contains a strong and substantial component that argues, from theory and empirical evidence that private ownership is superior to public in efficiency of resource use. As we look briefly at this literature it should be noted that very little of it is concerned with privatization as such. It is mainly devoted to comparisons between privately and publicly owned enterprises, which is not quite the same as comparing privatized enterprises with themselves (pre-privatization) or with public or always-private firms.

As noted above, most research on privatization has been descriptive in nature,

Group Meeting, Geneva, 17-21 August, 1992 (V.V. Ramanadham, coordinator).

¹⁸ It is sometimes difficult to disentangle management efficiency from the benefits accruing to a company which has substantial capital injections.

¹⁹ For example, **Christiansen, R. and Stackhouse, L., 1987**; "Privatization of Agricultural Trading in Malawi," Working Paper, Harvard University, John F. Kennedy

focusing on the process of privatization and its first round results.¹⁹ Among the few studies of the effects of privatization on relative performance of enterprises there are extraordinarily different results.

One group of researchers concludes that private enterprises are inherently more efficient than public enterprises.²⁰ Thus Borchering, Pommerehne and Schneider (1982) found that of 50 studies comparing costs in public and private enterprises, 40 concluded that private firms were more efficient.²¹

Similarly, Boardman and Vining (1989) analyzed the performance of the 500 largest, non-US mining/manufacturing enterprises to compare performances of private and public enterprises, and private and mixed enterprises. They found that public and mixed enterprises perform equally poorly, suggesting that private control is more important than having publicly traded stock. They conclude: (p.17) Athere is robust evidence that state enterprises and mixed enterprises are less profitable and less efficient than private corporations.

Boycko, Schleifer, and Vishny (1993) argue on the basis of agency-theory and qualitative analysis that only through privatization will soft budgets disappear and managers have the control rights needed to induce more efficient enterprise behaviors. They say:

School of Government, Center for Business and Government, Cambridge, Mass.
Leeds, Roger, 1987, ATurkey: Implementation of a Privatization Strategy,"**and 1988**, A Privatization in Jamaica: Two Case Studies," Working Papers, Harvard University, John F. Kennedy School of Government, Center for Business and Government, Cambridge, Mass.; **Wilson, E., 1987**, APrivatization in the Ivory Coast: Three Case Studies," Working Paper, Harvard University, John F. Kennedy School of Government, Center for Business and Government, Cambridge, Mass.; **Lorch, K., 1988**, AThe Privatization Transaction and Its Longer Term Effects: A Case Study of the Textile Industry in Bangladesh," Working Paper, Harvard University, John F. Kennedy School of Government, Center for Business and Government, Cambridge, Mass.; **Vuylsteke, C., Nankani, H. and Candoy-Sekse, 1988**, ATechniques of Privatization of State-Owned Enterprises," World Bank Technical Paper 88-90, World Bank, Washington, D.C.

²⁰ For example, **Boardman, Anthony E. and Aidan R. Vining, 1989**, "Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed, and State Owned Enterprises.," *Journal of Law and Economics*, 32 (1989), pp. 1-36.; **Boycko, Schleifer, and Vishny, 1993 et al.**

²¹ **S.V. Bercherding, W. Pommerehne and F. Schneider, 1982**, AComparing the Efficiency of Private and Public Production: The Evidence from Five Countries.," in *Zeitschrift fur Nationalokonomie*, pp. 127-56.

"There is virtually universal consensus that privatization improves efficiency."

However, many other researchers have found that there is no inherent deficiency in public ownership per se, but in market structure.²² The research by Foreman-Peck and Manning (1988) compares total factor productivity (TFP) of British Telecom with five telecoms elsewhere in Europe, with differing ownership structures. They conclude that there was surprisingly little support for conventional wisdom that private enterprises are generally more efficient than public enterprises.

According to a much-cited study: "There is no evidence of a statistically satisfactory kind to suggest that public enterprises in LDCs have a lower level of technical efficiency than private firms operating at the same scale of operation." (Millward, 1988. p.157) And a particularly influential study of railroad efficiency (Caves and Christensen, 1980, p.974) concludes:

Contrary to what is predicted in the property rights literature, there is no evidence of inferior efficiency performance by the government-owned railroad. Public ownership is not inherently less efficient than private ownership the oft-noted inefficiency of government enterprise stems from their isolation from effective competition rather than their ownership per se.

The need to look at market structure in making public-private comparisons, and to take account of the different objectives of state enterprises, is given emphasis in much research that discounts the ownership factor. Aharoni (1986) underscores the point that observable differences in profitability say nothing about how efficient SOEs are as users of resources. And Boardman and Vining then general conclusion that the evidence is robust that private firms are more efficient, hedge by saying that while the evidence gives an edge to the private sector, results vary between sectors. Where the SOEs show greater efficiency

²² See **Caves, D. W and L. R. Christensen, 1980**, "The Relative Efficiency of Public and Private Firms in a Competitive Environment: The Case of the Canadian Railroads.", *Journal of Public Economy*, 88, pp. 958-76; **Millward, R., 1982**, "The Comparative Performance of Public and Private Ownership.", Lord E. Roll, ed., *The Mixed Economy*, Macmillan, New York; **Millward, R. and D. M. Parker, 1983**, "Public and Private Enterprises: Comparative Behavior and Relative Efficiency.", R. Millward, D. M. Parker, L. Rosenthal, M.T. Summer and N. Topman, eds., *Public Sector Economics*, Longman, London and New York; **Borins and Boothman, 1985**; **Boyd, Colin W., 1986**, *The Comparative Efficiency of State-Owned Enterprise*, in Ananth Negandhi, Howard Thomas and K.L.K. Rao, eds., *Multi-National Enterprises and State-Owned Enterprises: A New Challenge in International Business*, CT JAI Press, Greenwich.

(as in power and water), competition is limited and private producers are regulated. Private efficiency seems relatively greatest in subcontracted service delivery where monitoring costs are low (e.g., garbage disposal, fire protection, non-rail transport)²³.

Galal, et al. attribute the contradictory conclusions in the literature to three factors. Some studies find private enterprises superior for illegitimate reasons: they compare competitive with monopoly enterprises. Some find them superior because they are comparing reasonably competitive firms. Finally, when monopoly enterprises are compared, Results are all over the lot.

RECENT IMPORTANT RESEARCH

The recent works by the Galal and Megginson teams 1994, and address some of the deficiencies of earlier studies and open new research directions.

First, they take pains to avoid comparing apples and oranges in terms of market structure. They also recognize that data constraints limit their methodological options. And they confront the slippery problems of measuring enterprises performance, notably with respect to taking SOE non-economic objectives into account. Galal et al. also construct counterfactuals, to make more ambitious with-without privatization comparison possible. We describe the approach and findings of each work separately, then assess them together.

The Welfare Consequences Book

The Galal et al. study examined 12 enterprises, three each from Chile, Mexico, Malaysia and the United Kingdom. They do what can be called enriched case studies, which combines intensive data collection on individual firms with institutional and historical material about environments surrounding each firm, and perform microeconomic analysis to derive quantitative estimates of welfare consequences of divestiture. The authors argue that econometric approaches alone leave out too much of the story. Analysis of institutional

²³ One of the best studies of public-private efficiency differences in service delivery is still the 1978 work of **Barbara Stevens, 1984, "Comparing Public and Private Sector Privatization Efficiency: An Analysis of Eight Activities,"** in *National Productivity Review*. In a regression analysis that took into account scale of operation, frequency and quality of service and other relevant variables, She found a large and statistically reliable cost advantage for private contractors for all the services except payroll preparation. The estimated excess cost of municipal delivery ranged from 37% for tree maintenance to 96% for street repair (asphalting).

influences and consequences is important, as are dynamic effects of divestiture, many of which may accrue only in the future.

They look at winners and losers & how benefits and costs are distributed between labor, employers, buyers, consumers, government and others. Perhaps most significant methodologically, Galal et al. attempt to overcome the problem of comparing like enterprises by assessing the >counterfactual,= that is, what would have happened to the divested enterprise had divestiture *not* occurred. By determining both the performance of the enterprise after divestiture and its hypothetical performance without divestiture, the analysts are able to compare the same enterprise, in the same time period and in the same macroeconomic environment. In theory, at least, this is a tremendous advantage to their research, since it avoids assumptions about a static economic environment, and about comparability of different enterprises.

In practice, however, it is more complicated. Statistical regression analysis would provide the best answers to the counterfactual question. But the problem is in obtaining sufficient data. As a result the researchers had to use *Afeel A* to derive from the data and the institutional environment to estimate whether performance changes are due to exogenous influences or to ownership changes. They were very conservative in that they assumed that all changes were exogenous unless there was strong evidence to the contrary. Most of the changes were positive, and as a result this approach probably underestimates the benefits which result from divestiture alone.

The *Welfare Consequences* study (like the Megginson et al. paper) finds evidence of improved enterprise performance and domestic welfare gains as a result of divestiture. Both demonstrate that well-implemented divestitures can yield significant efficiency gains.

In their sample of 12 enterprises, Galal et.al. estimate that improvements in net domestic welfare ranged from (-)2% to +145% of the enterprises= pre-divestiture annual sales, with a mean of 24% and a median of 5%. If gains in consumer surplus are factored out (because of the theoretical problems its use involves), the range of change is 1-68%, with a mean of 20% and a median 6 or 7%. Therefore they estimate an annual welfare gain of 5-10% of pre-divestiture annual sales, or a present value equal to 50-100% of sales.

Productivity increased in three-quarters of their cases. It decreased in no case. In four of the nine cases, productivity increase was due to management changes, while the work force remained essentially the same. In two of the nine cases productivity increase was due to labor reductions. In only one case did wage levels increase, but this was judged to be welfare neutral, as the employee gains were off set by profit reductions. Relaxing the investment constraint had surprisingly little effect. There were significant positive gains in only three cases, and negative effects (overinvestment) in just one case. Output prices significantly changed in 7 of the 12 cases, with little or no change in the remaining 5 cases. Overwhelmingly, the price increases moved towards efficiency in 5 of those 7 cases, with only 2 cases evidencing exploitative price increases. Input prices did not alter noticeably.

Because most of the studied firms were already operating under the rules of the

market as a result of previous reform programs, the researchers were somewhat surprised that marked welfare gains were experienced. They identified the causes for welfare gains as unexploited opportunities for profit maximization and better incentives, noting that "Even where public enterprises are relatively efficient, private ownership may still improve the principal-agent relationship, with positive results" (*Welfare Consequences*, p. 291).

In 11 out of the 12 enterprises examined there was a net welfare benefit, and in only 1 of the 12 cases were the researchers unable to find evidence of welfare loss to a specific group. In all other cases, while there are net benefits, there were definitely groups which lost as a result of the divestiture process. Pareto efficiency reallocation is apparently as elusive as perfect competition. However, there were no cases where workers as a class lost (>Workers= were defined to take account of their dual roles as wage earners and as buyers of shares.) While workers as a class didn't lose, there was only one case in which wages actually increased. Galal et al. conclude that it is possible to make workers no worse off. There may be cases where unions keep divestiture from happening because workers would be made worse off, but their point is that where there will be efficiency gains, those gains can be applied to counter workers losses. While the researchers cite examples of generous severance packages, etc., the reallocation of efficiency gains in order to benefit workers may be feasible in practice.

In 5 of the 12 cases consumers experienced welfare loss, three of which were substantial losses. Primarily this was due to price increases, however the researchers are uncertain whether the price increases were to an efficient level or whether they were raised to an exploitative level. In 4 of the 12 cases consumers actually experienced welfare gains, due to increased investment which yielded expanded services.

In assessing the distribution of benefits between foreign and domestic groups, the evidence indicates that while foreign actors gained, domestic agents gained by even more. In 9 of the 12 cases foreigners gains, while in 11 of the 12 domestic agents gained.

The *Welfare Consequences* book (like the Megginson et al. article) notes that prior and concurrent government policies substantially affect the realization of the goals of divestiture. In Mexico, divestiture occurred as a part of a massive stabilization package including trade liberalization, relaxed rules on foreign and domestic investment, deregulation and price reform, etc. The welfare gains experienced were attributed to increased labor productivity, desirable price reform (some up, some down) and the stabilization of the economy due to the macro policy changes. In addition, the larger economic reform package served to create and encourage investor confidence. In Chile also, researchers found that both prior and concurrent government policies were essential in obtaining the desired results from divestiture. In Chile the government introduced effective regulation in the case of monopolies, and for other enterprises introduced competition prior to divestment. These activities mitigated potential losses to consumers, and eased the burden on regulators.

In these circumstances, of course, it is much more difficult to assess the counterfactual, and to isolate the effects of divestiture from other macro economic policy effects. Accordingly, the researchers were unwilling (and unable) to separate divestiture from the larger

policy change in measuring efficiency change. Rather they assessed any welfare change as a result of the total policy environment.

Welfare Consequences. Demonstrates that fiscal impacts were positive. Profitability increased in all 12 cases, with an overall positive net fiscal impact in 9 of the 12 cases. Positive fiscal impacts of selling loss-makers can be dramatic. In Mexico, the divestiture of a loss making firm yielded a positive impact of \$2.68 billion from reduced losses in present value terms and from future tax payments. The net fiscal impact was valued at 62% of 1989 sales in perpetuity. In direct contradiction to popular expectations, Aa moribund, loss producing public enterprise can make a huge positive contribution to the fiscal situation of the government, even if it cannot command a positive sales price@ (p. 519). Either by absorbing all liabilities and selling only the assets, or by selling the enterprise at a loss and requiring the creditors to absorb the loss, the enterprise divestiture can still have a positive fiscal impact.

Thus in the cases studied, divestiture was followed most often by improved enterprise performance in terms of profit, efficiency and investment, and that net benefits were positive for employees, buyers, government, competitors, and consumers. Positive welfare effects are evidenced in both full and partial divestitures, in competitive and non-competitive markets, and in both developed and developing countries.

The Megginson, Nash and van Randenborgh Article

Megginson, Nash, and van Randenborgh solicited data from 149 companies, and assembled 61 usable time series data sets containing a large number of financial and operating ratios. They compare pre-and post-privatization behavior of these 61 companies, which were in 18 countries and 32 industries. The sample included cases of both full and partial privatization achieved through public share offerings (1961-1990).

Megginson et al. find that post-privatization profitability rises for firms in competitive industries, for both partial and fully privatized firms, for both control and revenue privatizations (where the government sells less than a majority of its shares), and for both OECD and developing countries. In addition, they find reduced debt ratios and increased dividend payout. The authors reject price increases as the source of the profitability improvement. Instead, they attribute the improved performance to the Ainternalization of the benefits of performance improvements and publicly listed shares [which] allow these benefits to be capitalized into the price of the firm=s stock@ (p 448).

Megginson et al. also find improved efficiency in the use of labor, financial and technical resources for competitive industries, for full as well as partial privatizations, for control privatizations and for OECD countries. For revenue privatizations and for those occurring in developing countries, efficiency also improved but at insignificant levels. Employment increased in two-thirds of the cases, and only in two cases (both in the UK) was employment cut. This finding of course runs counter to widespread assumptions about disemployment effects and to the popular idea that efficiency is obtained only by sacrificing non economic and political goals.

Capital investment levels improved, reflecting an evident shift from labor-intensive methods previously favored, and also reflecting technological updating. However the improvement was not nearly so dramatic as was expected. Improvement was only significant for competitive enterprises, full divestitures, control privatizations and OECD countries, and was not significant for industries where regulatory control is established, for partial divestitures, for revenue privatizations (as opposed to control privatizations, where the purpose is to raise fiscal revenue). Nor was there an investment increase in the sampled developing countries. This may indicate that where the government retains some form of control or responsibility for the organization, investment injections are not so forthcoming.

Assessment

These new studies represent major advances in knowledge about privatization effects or impacts. Unlike most of the previous writing on relative performance of public and private firms, these researches put *privatized* enterprises, not private enterprises in general, at center stage. In addition, they are methodologically adventurous. *Welfare Consequences* breaks particularly interesting new ground by its enhanced case study approach, its resort to counterfactuals and its quantitative estimates of aggregate benefits and their distribution among stakeholders.

The contributions of this book have been hailed elsewhere.²⁴ The merits of the Megginson et al. piece have also been widely noted. It is most useful here to consider some of the limitations of these excellent works.

One crucial shortcoming of both the Galal and the Megginson groups' research, in terms of the generalizability of their approach and their results, is that none of the firms they studied is in a low income country or a transition economy. Only about one in five of the Megginson sample is from developing countries, none of them a low income or transition economy. (The developing countries from which firms were selected were Korea, Chile, Jamaica, Malaysia, Mexico and Singapore). The Galal et al. study suffers the same shortcoming. The 12 firms they studied were in the U.K., Mexico, Malaysia, and Chile. Both studies lament this weakness in their samples, and acknowledge that it probably limits the generalizability of their results. But it was imposed by data constraints.

The attribution issue raises a second major problem with the findings of the two studies. Disentangling the effects of divestiture (ownership changes) from those due to improvements in the overall macroeconomic environment is next to impossible, as we noted

²⁴ See the contributions to **A. Galal and M. Shirley, eds.**, 1994, *Does Privatization Deliver? Highlights from a World Bank Conference*, Economic Development Institute, World Bank, Washington, D.C.

earlier. Both studies accept this reality. Galal et al. note that it exists, and conclude that they cannot attribute the welfare gains they found to privatization alone, since positive changes in incentive structures and general macroeconomic environments also were at work. The Megginson et al. piece essentially passes over this issue. They do exclude privatizations involving primary offerings and focus instead on purely secondary offerings (where the government sells its stake rather than the enterprise offering new shares to raise revenue). In this way they believe that any improvements in performance documented after divestment must be traced to changes in incentives, regulation, macro political or ownership structures, rather than cash injections into the firm from a new capital issue (p. 420).

Along the same line, but less crucial, Megginson et al. do not address the counterfactual question. And while *Welfare Consequences* does so at length, its authors rely on assumptions and educated judgments when constructing the counterfactual. This meets some methodological objections, but at a cost; it raises the level of uncertainty about the magnitude of the net welfare benefits, and reduces the level of credibility of the quantitative results.

Another limitation in both studies is that much privatization is ignored; their inquiry examines traditional divestiture only. Neither of the studies looks at methods of privatization short of divestiture, such as management contracts, leases and concessions, contracting-out. Their sample of divestitures was further constrained by their data needs. Both studies use data on companies which were privatized through public share offerings, because post-privatization data (financial and accounting) is still made available. However, both studies note that companies privatized in this manner tend to be very large, well-managed, and transparent in their operation. Moreover, they operate in countries with relatively well-developed financial and regulatory systems. Such firms are few. Both sets of authors cast their nets very wide for usable case studies, and both had limited catches. This means the replicability of the research will not be easy.

One disappointment with *Welfare Consequences* is that generalizations about its results are not readily apparent. In the summary statements presented at the Economic Development Institute workshop (Galal and Shirley, eds., 1994) productivity effects are given short shrift and investment effects are said to have been strong. But this is not really clear from the text and other summary statements. As one participant in the workshop (Johannes Linn) said: "There seems to be very little pattern to the results. The effects are all over the place. So you have a situation with no strong, clear set of conclusions."

Similarly, despite their optimistic assessments of the welfare-augmenting impacts of divestiture and its positive fiscal effects, Galal et al. are extremely reluctant to extract general policy recommendations from their findings. They state that ownership matters, but that gains are contingent upon policy makers," and that the origin and distribution of welfare

²⁵ The authors says it this way: "We cannot use the fact that our cases were on

effects of divestiture reflect initial condition of each enterprise, its sector, political characteristics, and the nature of the sales transaction (Galal et al., pp.294, 534).²⁵

Unpredictability of results and the need for good accompanying policies are obvious points, easily accepted. More interesting is the mild backpedaling of Galal et al. from the conclusion that ownership matters, which occurs in their discussion of partial privatizations.

The authors argue from Malaysian experience that even partial divestiture which does not entail private majority ownership or control can result in efficiency gains. In Malaysia, all of the cases studied were partial privatizations. In one instance the government sold a controlling interest. In another it sold only a minority interest. And in the third case the government sold a minority interest and controlled management indirectly through share ownership by other public or quasi public enterprises. Even if the government kept control, managements adjusted well to external changes and efficiency gains occurred.²⁶

These findings seem to instill doubt among the researchers regarding the necessity of divestiture. The authors state that many gains associated with divestiture could be achieved through implementation of public sector reform with emphasis on applying market principles to public enterprises. So ownership doesn't really matter in principle. The problem is that governments can be counted on to implement and sustain the policies that could make state-owned firms as efficient as private enterprises.

As innovative and impressive as the Galal et al. study is, the methodological and analytic mountain seems to have produced a policy mouse. Even on the central general issue of whether ownership matters, their answer turns out to be ambiguous. That this is unsettling, is evident in the reaction of some perceptive readers.

Perhaps the single most disappointing aspect of the study is that it does not provide a clear, unequivocal answer to the question, A Does ownership matter? In any case, it has not changed my mind on the

balance overwhelmingly successful to *predict* comparable success elsewhere. Success was caused, not by the simple act of divestiture alone, but by divestiture in combination with a set of intelligent, accompanying policies, most notably regulation and sales conditions. The governments of the countries in the sample were generally doing a lot of things right in the economic arena and were divesting into relatively well developed markets. Where conditions are not comparable, results may differ.

²⁶ The case for partial (temporary)divestitures is strengthened by evidence demonstrating the increased gains to the government as a result of reduced uncertainty, which increased share prices. In Mexico, as in Malaysia, government sold shares in three tranches. As a result they were able to capitalize on rising stock prices, and to allow the early investors to gain rapidly, thereby creating a huge investor interest.

topic. I came in with a fairly strong opinion about that issue. But I think that if you try to use the study to convince people who doubt it that ownership really matters, you may have trouble fully convincing them. I do not think that this is a sign of any weakness in the study. I think it is just the nature of the exercise you are engaged in.²⁷

FURTHER RESEARCH

1. Industrial enterprises should be included in future case studies of enterprise-level impacts of privatization.
2. Subsequent research programs should attempt to confront some of the weaknesses of the Galal and Megginson pieces. For example, samples must include low income countries and transition economies. In addition, methods of privatization other than classic divestiture should be analyzed. Lastly, researchers must either find ways of adequately asking the "counterfactual" questions and of isolating privatization's impact, or must accept the limited nature of the research results.

²⁷ **Johannes Linn** comment in **Galal and Shirley eds.**, 1994, EDI, p.120.

VI. FISCAL EFFECTS

Relief of budget burdens is one of the two most common reasons why governments adopt privatization programs; the other is increased efficiency. It is not usually recognized that the achievement of the fiscal relief objective is largely dependent on the achievement of the second. Properly analyzed, many privatization transactions are seen to represent a simple exchange of assets between private and public sectors, and a shift over time in government's flow of revenues and expenditures. Unless something else happens – especially an increase in efficiency of use of the privatized assets – positive fiscal impacts are likely to be small and might even be negative.

The underlying analysis is straightforward.²⁸ In general, sale of public assets leads to a once-and-for-all reduction in the overall budget deficit, unless the sale price is less than the income that would have accrued to government. On the assumption that the price paid by the private buyer is a fair market price²⁹ and that the SOE's future earnings stream is positive, the overall deficit will be smaller at the time of sale, but there will be larger future deficits, due to reduced revenues (from profits) to government.

Theoretically, these larger future deficits would be exactly offset if government used sale proceeds to buy other financial assets or to retire equivalent amounts of outstanding debt. The government and the private sector, then, are simply exchanging financial assets and liabilities. The fiscal position of government is permanently unaffected by the privatization. This is true, other things equal, unless there occurs an increase in efficiency in the privatized enterprise, in which case income, profit, and tax revenues will increase. It should be noted that if government uses the proceeds to finance a temporary increase in current expenditure (or to reduce taxes), and nothing else changes, the year of sale deficit will be smaller but future deficits will be bigger.

If the privatized enterprise is a money-loser and is expected to lose money in the future (the present value of its expected future net profit stream is negative) then there can be no increase in current expenditure. If the SOE is sold at a competitive market price, the buyer will have to be subsidized. Setting aside complications about how and when the subsidy is

²⁸ The discussion here follows **Richard Hemming and Ali Mansoor, 1987, A Privatization and Public Enterprises,** Working Paper 87/9, Fiscal Affairs Department, International Monetary Fund; and **Ali Mansoor, 1990, The Fiscal Impact of Privatization,** in Paul Cook and C. Kirkpatrick, "Privatization in Less Developed Countries: An Overview," in same authors, eds., *Privatization in Less Developed Countries*, London.

²⁹ This is defined as a price equal to the present value of the discounted stream of after-tax net earnings of the enterprise.

paid, the initial deficit will be larger and future deficits smaller. Again, there is a simple exchange of assets, without affecting government's overall fiscal position over time.

In practical terms, policy makers rarely assess net effects over time on fiscal stance. They see the immediate effect of an asset sale as a reduction in the budget deficit by the amount of the proceeds from the sale plus reduced transfers (subsidies) if any, minus any costs associated with the sale such as payment of debt and severance pay. The effect should be translated into an improvement in financial flows between public enterprise sector and central government budget (reduction in subsidies or increases in revenues).

Since many SOEs are money-losers, and for the bulk of them future earnings prospects are negative, it is understandable why divestiture is often believed to lead to automatic lightening of fiscal burdens. It is nonetheless important to recognize impacts on government's net worth, as well as on revenue and expenditure. It is important also to understand that how revenues from privatization are spent is a significant factor in assessing fiscal impact. Most important in assessing the impact is the resulting change in enterprise efficiency of any, and further downstream impacts.

ECONOMIC IMPACTS OF SOE DEFICIT REDUCTION

The analytic links running from privatization to SOE deficit reduction to GDP growth and greater economic welfare are rather loose. They undoubtedly exist, but efforts to quantify them are few and unconvincing. The authors of the World Bank report, *Bureaucrats in Business* argue that subsidies to SOEs absorb resources that could otherwise be used for basic health and education, which are generally regarded as positively correlated with economic growth. Diversion of central government subsidies entirely to basic education would, they point out, increase those expenditures by half in Mexico, 74% in Tanzania and 550% in India. (However, if losers are sold with subsidy to buyers government does not have resources.)

It is however the case that in many countries, especially low income, the biggest absorbers of subsidies are basic public services, including higher education. Until recently few of these have been candidates for privatization. And spending on basic education is not particularly efficient in these countries;; much of any increase would go to higher salaries, with uncertain impacts on quality.

The more traditional and significant arguments are that SOE deficits are often a substantial part of total budget deficits, and reduction of the latter will tend to have positive

³⁰ cf. **Stanley Fischer, 1993, "Role of Macroeconomic Factors in Growth," *Journal of Monetary Economics*, December, pp. 485-512.**

macroeconomic effects and hence spur faster growth. Many studies show that big budget deficits induce high inflation rates, which are negatively correlated with GDP growth.³⁰

The link between SOE deficits and overall budget deficits appears to be close. Data collected in *Bureaucrats in Business*.. show that for 38 LDCs from 1978-1991, SOE sector deficits moved closely with overall fiscal deficits (and with current account deficits). Since the SOE deficits averaged 35% of the total deficit in these 38 countries, it is reasonable to assume that reduction in SOE deficits will lead to smaller fiscal and current account deficits, and lower inflation. The greater macroeconomic stability will lead, other things equal, to faster growth.

For many reasons, perhaps lack of data above all else, it seems that nobody has tried to model and quantify this chain of effects from privatization to growth.³¹

EMPIRICAL EVIDENCE

Shirley and Galal show in *Bureaucrats in Business* that SOE deficits are a big proportion of general fiscal deficits and their changes are highly correlated. They also show that over the whole era of privatization@ (late 1970s to early 1990s) reductions in fiscal deficits have not been general in the developing world. They calculate Asavings-investment@ deficits (difference between SOE sectors current surplus and investment, which is filled by government budget transfers, private domestic savings or foreign borrowing, or all three). Their data show that from 1978-1982 average deficits in 46 developing countries grew (to about 3% of GDP in 1982), fell sharply between 1982 and 1985 (to an average of about 0.5%), then remained unchanged at around 0.8% until 1992.

All the improvement, however, took place in 29 middle income countries. In the 17 low income countries in their sample, average annual deficits rose from about 0.5 % in 1985 to almost 1.0% in most years up to 1992. In other words, in those countries where SOEs are

³⁰ cf. **Stanley Fischer, 1993, "A Role of Macroeconomic Factors in Growth,"** *Journal of Monetary Economics*, December, pp. 485-512.

³¹ It will be recalled that the authors of the *Welfare Consequences* book strongly argued that the efficiency increases noted in their case studies could not be attributed to privatization along and they equally firmly stated that their findings were not extendible to other countries and companies. It is amusing that *Bureaucrats in Business* contains a footnote giving a rough estimate of the impact of divestiture on growth in the typical LDC. It says that assuming annual average welfare gains from divestiture to be about 8% of predivestiture sales, divesting half the typical SOE sector in developing countries would yield a gain equivalent to 1% of GDP, other things equal. By Galal et al. 's own earlier argument, such a calculation is illegitimate.

most inefficient and run the biggest deficits, countries where SOE deficits moreover tend to make up the biggest share of total deficits, no positive fiscal impacts are observable.

This lack of deficit reduction in so many countries may explain why there seem to be few country studies that discuss fiscal impacts in detail.³² The most intensive analysis seems to be that of Dominique Hachette and Rolfe Luders. They give a major chapter to analysis of the effects of privatization on government revenues and on government net worth. They also try to assess whether fair prices were paid, and they comment on the first round expenditure consequences of the inflow of revenues from privatization. Their discussion is opaque in spots, but they touch most of the right bases.

Their main findings are not easy to discern. Much of the analysis is excessively succinct and hence hard to follow. The reader is easily lost among the many distinctions they make: short term from long term effects, first divestiture round effects from second, revenue/expenditure effects from net worth (balance sheet) results and direct from indirect impacts.

One finding is quite clear. Divestiture reduced expected government revenues, from a medium term perspective. At the time of divestiture, the SOEs (which were run relatively efficiently) were generating net revenues for government. The first round of privatization produced fresh revenues. But these were consumed by social expenditures. During the second privatization round, the sales proceeds were partly used for non-revenue producing public works. Once the proceeds from divestiture had been spent, government received only tax revenues from the privatized enterprises.

From a longer term perspective, the fiscal effect was positive. This is because in Chile, as elsewhere, government before divestiture made net contributions to investments of SOEs. After divestiture there were no longer required. So divestiture allowed the level of discretionary public expenditure to be higher.

One important fiscal dimension is not taken up by Hachette and Luders and is frequently neglected in discussions of fiscal impact. Very little attention seems to be given in existing literature to indirect subsidies: tax and accounting code advantages, import concessions, cheap credit, access to foreign exchange at official rates in distorted situations. Calculations of public enterprise sector deficits, whether as net financial transfers or "savings-investment" deficits as in *Bureaucrats in Business*, neglect to take these indirect subsidies into account. Yet they are often greater in magnitude than direct subsidies, and their economic effects are more pervasive and distortionary. Both country studies and enterprise level analyses can shed needed light on this phenomenon.

³² For developing countries in particular. See for a provocative recent discussion, Quiggen, J., "Does Privatisation Pay?" in the *Australian Economic Review* (2) 1995, pp. 23-49.

FURTHER RESEARCH

1. Industrial enterprises should be included in future case studies of enterprise-level impacts of privatization.
2. Subsequent research programs should attempt to confront some of the weaknesses of the Galal and Megginson pieces. For example, samples must include low income countries and transition economies. In addition, methods of privatization other than classic divestiture should be analyzed. Lastly, researchers must either find ways of adequately asking the >counterfactual= questions and of isolating privatization=s impact, or must accept the limited nature of the research results.

VII. THE ECONOMIC AND SOCIAL IMPACT OF PRIVATIZATION ON LABOR

INTRODUCTION

Any large scale privatization program will affect broad sections of society, ranging from government ministers and civil servants to the managers and workers in industry. Those employed in privatized factories and organized labor whose leaders have gained both power and privileges within medium and large firms owned by the state are two of the many groups both positively and negatively impacted by privatization. Donor organizations are eager to encourage economic liberalization and stabilization, and view privatization as one means by which these goals are reached. Measuring the impacts of privatization on an enterprise, on an industry, and on an economy, is essential in order to reinforce the benefits of privatization. No less important is the measurement of privatization's impact on labor, since a positive impact can elicit support for the reform package, while a negative impact can bring reform programs to a standstill. Accordingly, donors pay particular attention to programs which address the impacts (real or perceived) of privatization, and devise programs through which they hope to offset any negative impacts.

MEASURING THE REAL ECONOMIC IMPACT OF PRIVATIZATION ON LABOR

As a macro economic stabilization tool, privatization is increasingly regarded as the primary method for the state to significantly reduce the strain on the public budget, and to significantly improve the efficiency and profit margins of weak, inefficient, state owned enterprises (SOEs). Privatization is expected to increase enterprise profitability, operating efficiency, capital investments and output. It is also generally assumed, by opponents of privatization, that these benefits will be achieved at the cost of the social and political goals which, prior to privatization, were the driving motivation behind most SOEs. One of the most sensitive costs of privatization is employment.

There are several ways, theoretically, to measure the impact on labor. For example, the terms of divestiture may require the new employer to retain all or part of the employees of the PE. If the sale requires retention for a given period, a count can be made of those still employed after the period, even though it will be difficult to prove that discontinued employment resulted from privatization. Adding to the difficulty, specific case by case inquiry may have to be undertaken to determine these figures, since Labor Departments in many developing countries have neither the manpower, nor the interest, to maintain these records once a firm has been divested. Another possibility is to analyze the records of government retraining facilities for displaced PE workers to obtain specific numbers of graduates and job placement records. This may help to determine how many former employees were motivated to secure additional training in order to return to the labor market.

Given how important reliable data and analysis on impacts can be, the paucity of factual, empirical studies which support the implicit assumptions regarding the efficiency of private versus public enterprises and the effect of privatization on labor, is surprising. Measurement difficulties stem from a number of factors which preclude close statistical measurement of the impacts of privatization on labor. These factors include the development of market systems, macro economic stabilization, capital market development, labor mobility, acquisition of technical skills within the labor force, and the effectiveness of the social safety net. While certain aspects of labor can be fairly accurately measured (such as redundancy rates and income levels) these other factors are so closely intertwined with overall aspects of the development of a national economy that it is difficult to distinguish and measure them purely in terms of their impact on labor.

On the other hand, evaluating privatization outside of the context of national growth is not an option. Since obtaining employment information requires studies of individual privatizations over a period of years, at best figures will suffer from distortion if the overall growth of the economy is not factored in. In addition, a variety of factors will need to be measured and corrected over a substantial period of time to draw any conclusions. As a result, assessing the true impact, in the short and long run, of privatization on labor is a difficult task.

Research Methods

Early research provided little in the way of substantive evidence of the impact on labor. Most of the early works were descriptive in nature. There were comparatively fewer studies which analyzed the outcome of privatization and its effects on the various stakeholders. Equally problematic was the lack of consensus that the early studies were able to provide. Focused on the process of privatization and providing little more than case studies illustrating privatization's impact on labor, policy makers were not provided with any concrete data in support of labor benefits resulting from privatization. For the policy maker, this research gap presented a dilemma. Case studies were touted on both sides of the ideological fence, some arguing that privatization provided labor with improved job and training opportunities, and increased wages, and others arguing that privatization meant job loss, unemployment, and the loss of the social safety net.

It was not until recently that more reliable evidence was presented suggesting that the anticipated labor loss had not occurred, at least in some instances of large scale privatization in various parts of the world. Galal, et. al., (1994) and Megginson, et. al. (1992) concluded that there was little or no negative impact on labor as a whole. Both research studies are significant in that they both attempted to overcome some of the limits of earlier research, such as performance measures and the difficulty in isolating the impact of divestiture.

The Galal study examined 12 enterprises, three each from Chile, Mexico, Malaysia, and the UK. They compiled as much empirical data which could be made available to them, and then supplemented it with detailed case studies. The research analyzed not only the net benefits from

privatization, but also the distribution of benefits between labor, employers, buyers, consumers, government and others. The authors rightly argued that econometric analysis, on its own, precludes analysis of institutional influences and neglects the dynamic effects of divestiture, many of which may accrue only in the future. In order to capture all possible changes resulting from divestiture, Galal then takes the research another step further, and projects the effects into the future in order to capture both the flow and the once-only items. This is an important, but often neglected, step in the research process of capturing the immediate changes as well as those which take longer to manifest, such as organizational change.

Most importantly, Galal attempts to overcome the problem of isolating divestiture's impact by assessing the counterfactual, that is, what would have happened to the enterprise if divestiture had *not* occurred. This is a second improvement to the research methodology. By determining both the performance of the enterprise after divestiture and the hypothetical performance without divestiture, the researchers are able to compare data from the same enterprise, during the same period of time, experiencing the same macro economic changes and the same market dynamics. In theory, at least, this is a tremendous advantage to their research, rather than assuming a static economic environment, or assuming that differing enterprises can be fairly compared.

In practice, however, it is more complicated. Statistical regression analysis would be the best method by which to answer the counterfactual question. Once again, though, the problem is in obtaining sufficient data. As a result the researchers had to rely on gathering relevant economic data, in addition to institutional and case study analysis, and then use their own judgement in determining whether changes were due to exogenous influence or due to ownership changes. To be fair, they did adopt a conservative approach which assumed that all changes were exogenous unless there was strong evidence to the contrary. As most of the changes were positive, this approach probably underestimates the benefits which result from divestiture alone.

Meggison, Nash, and van Randenborgh (1994) also attempted to overcome some of the problems in the earlier research, namely the limited sample sizes. After soliciting data from 149 companies, they compared pre- and post-privatization behavior of 61 companies in 18 countries and 32 industries, including both full and partial privatization achieved through public share offerings (1961-1990). One of the weaknesses, however, of the Meggison piece is that there is no control group of enterprises which remained public, or were already private. Moreover, the research does not address whether the changes are due to privatization alone, as separate from other macro economic influence.

A weakness of both the Galal and the Meggison research is that, of the firms they evaluated, none represent the least developing countries or transition economies. In the Meggison study only 22% of the enterprises were from developing countries, none of which were transition economies, African economies or could be classified as a least developed country (the countries evaluated were Korea, Chile, Jamaica, Malaysia, Mexico and Singapore). The Galal study suffers the same weakness; the countries they examined were Mexico, the United Kingdom, Malaysia, and Chile.

Research Results

Both the Galal and Meggison studies find evidence of benefits which accrued to labor as a

whole, as well as improved enterprise performance and domestic welfare gains that result of divestiture, if the program is wisely implemented. In the Galal sample of 12 enterprises, the change in net domestic welfare ranged from (-)2% to +145% of the enterprises pre-divestiture annual sales, with a mean of 24% and a median of 5%. If gains in consumer surplus are factored out, the range of change is 1-68%, with a mean of 20% and a median 6 or 7%. Therefore they estimate an annual welfare gain of 5-10% of pre-divestiture annual sales, or a present value equal to 50-100% of sales.

In 9 of the 12 cases productivity increased (decreasing 0% of the time). In four of those nine cases, productivity increase was due to management changes, while the work force remained essentially the same. In two of the nine cases productivity was due to labor reductions. In only one case did wage levels increase, but it was judged to be welfare neutral, as the employee gains were off set by profit reductions.

The major impact of divestiture on labor in some studies has been the replacement of public-sector pay and incentive structures with structures designed to improve productivity, quality, customer service or innovation. In one of the Galal *et al* studies (Malaysia) managers set incentives so that real wages were increased by 70 percent by the private managers, and so that labor was involved in management decisions. The same workforce, without further training, was able to increase its output by two and a half times, reducing turnaround time, and intermediary input costs fell as workers took on odd jobs formerly subcontracted out in periods of low activity. This case is especially remarkable as government continued to own 90 percent of the shares in the company.

Any interpretation of research results must differentiate between group and individual benefits or losses. First we must distinguish between net welfare gains to all stakeholders combined, and gains specific to the various stakeholder groups. In 11 out of the 12 enterprises examined there was a net welfare benefit, yet in only 1 of the 12 cases was there welfare gain for all groups. Next we need to distinguish between the types of gains and losses which are experienced by a specific group. For example, while there were no cases where workers as a class lost, there was only one case in which wages actually increased. The gains to workers may have been from severance pay offered, from share appreciation, from increased training, etc, but was not likely to come from higher wages resulting from greater managerial efficiency and increased productivity.

This is an important distinction for policy makers, because even though there may have been a net gain statistically, depending on the composition of the other gains and losses felt, the individual workers may still perceive the divestiture process negatively. Severance pay, training, and company shares may have little or no perceived value as compared to increased wages or continued employment. These individual losses contribute to an overall negative perception of the privatization program (discussed later in this chapter), and can be detrimental to the goals of reform unless they are mitigated or compensated.

GAPS IN RESEARCH REGARDING LABOR IMPACTS

Notwithstanding the marked improvement in the research techniques utilized in the Galal and

Meggison studies over earlier descriptive studies, and the amount of evidence supporting efficiency arguments for divestiture, there are a number of caveats in the research which the authors themselves note, without which the findings cannot be applied. The applicability of these studies is limited by the precision of their research findings, the specific type of privatizations evaluated, the social, political and macro economic environments in which they occur, and the absence of data or case studies from developing or transition countries.

1) One major drawback to the research study is that Galal defined >workers= to include both their roles as wage earners and as buyers of shares. In the ten cases where the workers gained most, it may have been through post-privatization share appreciation where employees were able to buy stock in the new firm. This continued to be true even after adjusting for those who lost their jobs as a result of privatization, after adjustment has been made in the calculations for severance pay, the expected time out of work, and the expected earnings when the ex-employees return to work. In the middle income country privatizations analyzed in Galal et.al, worker benefits as shareholders are significant, however this may not hold true for lower income countries and those in transition.

2) A second major weakness of both works is the precision with which efficiency effects and welfare benefits can be attributed to divestiture alone. The Meggison piece fails to address the counterfactual question completely. They do exclude privatizations involving primary offerings, instead focusing on purely secondary offerings (where the government sells its share rather than the enterprise offering new shares to raise revenue). In this way they believe that **A**ny improvements in performance documented after divestment must be traced to changes in incentives, regulation, macro political or ownership structures, rather than cash injections into the firm from a new capital issue@ (Meggison, 420). Unfortunately, while they isolate effects from new capital injection they do not isolate factors related to privatization as separate from changes in incentives, regulation, or macro political factors. The reader must also remember that even the Galal piece is forced to rely on **A**ssumptions and educated judgments@ when constructing the counterfactual, given the lack of empirical data (Galal, 536). This, of course, constrains the amount that can be generalized from their studies, a point which the authors readily admit.

3) Another constraint to the research is that they examine traditional divestiture methods only. They do not analyze management contracts or leasing, liberalization and incentive structures, or public private partnerships. Both the Galal and the Meggison studies use data on companies which were privatized through public share offerings, because post-privatization data (financial and accounting) is still made available. However, both authors note that companies privatized in this manner tend to be very large, usually very visible and politically sensitive. This does raise the question of what might happen in smaller firms that are no longer in the public purview **€** whether they will react in an equally sensitive manner, politically and socially, when it comes to improving performance.

4) For all of their optimistic assessments of the role of divestiture in raising economic welfare to various groups, including labor, and in having positive fiscal effects, Galal cautions that their findings should not, and cannot, be applied randomly to other countries and situations. They note that while ownership matters, the likelihood and magnitude of the benefits from divestiture are determined by accompanying government policies. In fact, they repeatedly caution against applying their results to other cases, arguing that **A**gains are contingent upon policy makers@ (Galal, 294), and that the **A**origin and distribution of welfare effects of divestiture...reflect initial condition of each enterprise, its sector, political

characteristics, and the nature of the sales transaction (Galal, 534).

The country's economic state, as summarized in the development of market structure, the civil service, and the capitalist-managerial class, help to define what the goals of divestiture and macro-economic policies should be. Achieving those goals, however, is constrained by socio-political circumstances, the strength of the government, the prevailing attitude toward or understanding of capitalism in the society, and the strength of collective bargaining institutions. It is also limited by the policy environment as consisting of a competition policy, regulatory environment, the role of foreign participation, and the attitudes towards partial or full divestiture (arguing that what matters is not the government's right to intervene, but rather how it intervenes). The authors themselves recognized the extent to which the research findings could be applied, stating that:

We cannot use the fact that our cases were on balance overwhelmingly successful to *predict* comparable success elsewhere. Success was caused, not by the simple act of divestiture alone, but by divestiture in combination with a set of intelligent, accompanying policies, most notably regulation and sales conditions. The governments of the countries in the sample were generally doing a lot of things right in the economic arena and were divesting into relatively well developed markets. Where conditions are not comparable, results may differ. (Galal, 570)

5) The fifth and final factor which limits the extent to which the research can be generalized is the absence of enterprises examined which are located in the least developed countries or in transition economies. In fact, serious consideration should be given to the fact that the Galal research sample included only four countries (UK, Malaysia, Mexico, and Chile). While three can be characterized as >developing= countries, they are certainly among the richer of the developing countries. There is no comparison between the sample countries and transition economies or the less developed >developing= countries where the task is two fold. Not only are governments divesting public enterprises, but they are simultaneously creating the markets into which they are divesting, the civil service and regulatory institutions which will facilitate the process, the capital markets to finance divestiture, and a knowledge base of capitalism among their constituents.

It is clear that, in view of the authors' strong cautions, the evidence they present in support of divestiture as a means of improving enterprise efficiency, increasing net welfare, and improved benefits to labor, cannot be used predictively. Rather, the evidence must be used prescriptively, to illustrate what *can* happen in situations with similar macro-level influences. Ownership matters, but the authors overwhelmingly find that a host of other factors ultimately determine the extent, and distribution, of the potential net efficiency, fiscal gains, and benefits to labor.

As the statistical evidence on privatization in general is limited, we need to increase our understanding of, and information about, two other important areas: the ramifications of mass privatization on labor, and the degree to which the perceptions of privatization and its impact on labor can be controlled. Each of these areas can be vitally important to the local decision maker, and should not be overlooked by researchers, consultants, and international donor organizations.

LABOR AND MASS PRIVATIZATION

The impact on labor of mass privatization differs in many ways from that of privatizing by sale of industrial PEs to private sector buyers, and is a subject that must be researched as it is the preferred method of divestiture in transition economies, especially the former command economies of Eastern Europe and the new states of the former Soviet Union. By using the voucher or coupon in an effort to redistribute the assets of the PEs to as large a part of the population as possible, mass privatization has operated with varying degrees of success. Much depends on the stage of development of the banking and financial structures of each country, the determination of the government to privatize, and the capabilities of the bureaucracy to handle the complexities of the coupon distribution system.

From labor's point of view, privatization, either in the classic form of direct sale or in the mass redistribution of ownership, will be of little advantage unless it results in a marked increase in job creation as the size of the labor force increases. Changes in ownership under mass privatization may give some psychological satisfaction to the work force, but may in reality offer little of substance. The ability to acquire a few shares of the firm in which the worker is employed offers little guarantee of a voice in wage levels and working conditions; operating decisions will remain in the hands of management. Short of effective representation of worker shareholders on the firm's board or of united action on the part of all the labor shareholders in opposition to management's direction, little meaningful change may come about. Indeed, factors such as markets, prices, technological advances reducing the work force, and currency inflation remain beyond the influence of either shareholders or management. The strike as a weapon to force compliance with workers' needs becomes less effective since workers are seen as striking against their own best interests should production be reduced.

More importantly, the real impact of mass privatization has yet to be seen, especially in those countries where the government retained a large number of shares in the privatized enterprise. For example, success was attained in Russia where large numbers of small enterprises were sold to worker groups, to their current operators, or to new entrepreneurs. Medium and large enterprises were divested by investment vouchers sold at a nominal price to the public; as a result thousands of new investors were created, some of whom profited, by the subsequent sale of these vouchers to mutual investment funds. The voucher system gave the workers, for the first time, a direct interest in the successes of the businesses in which they now had at least an ownership stake.

While the Russian privatization exercise worked well for the smaller units, it was less successful for major industrial operations. Ownership by large numbers of small investors meant that management was able to regain control by acquiring substantial numbers of the distributed vouchers. Moreover, acquisition of shares by workers and the public brought no new capital and technical expertise to the firm and consequently created few, if any, new jobs. Under a later phase of privatization, new provisions prevented workers from acquiring 51% control of the firm and management could no longer acquire controlling interest. The

objectives shifted to attract private investment and technical and marketing skills by sale of shares to large foreign or domestic investors; this was especially true in the case of defense conversion industries. This may have met the goals of the government, but it reduced the putative advantages of privatization to the workers since it limited labor input into management decisions on the assumption that workers prefer this input to wages.

The Czech Republic had similar experiences, even though the privatization effort was widely perceived to be very successful. Estimates in 1994 were that 65% of GDP was produced in the private sector, in direct contrast to estimates of less than 4% in 1989. However two aspects of the program limited its potential and, to date, have postponed the inevitable restructuring which will greatly impact labor.

First, the state privatization agency retained control over 20% of the shares in each joint stock company created, and has authority to appoint representatives to the boards of each company. That degree of control, relative to the numerous small stakeholders, means that the government has a strong voice in how, when, and which firms are restructured. Second, the government was extremely reluctant to pass bankruptcy legislation. In addition to concerns about high levels of inter-enterprise debt leading to the collapse of several enterprises, the government's primary motivation was to maintain a 3% unemployment rate (near 0% in Prague). Przeworski notes that it was fear of unemployment, on the part of the public, which led to the leadership changes in Poland and Hungary.³³ Thus not only was the state retaining control over productive assets, it was also continuing subsidies to loss-makers and preventing the necessary restructuring in order to improve enterprise efficiency. Accordingly, the impact on labor has been postponed, and cannot at this point be accurately assessed.

One of the many debates regarding privatization in transition economies is whether it is, as some economists have argued (e.g. Krueger, 1992), more beneficial to labor interests to create new enterprises than to privatize existing PEs. Governments and international donors should concentrate on creating an economic environment conducive to the establishment of new companies more suited to the needs of a market economy, rather than focusing on outmoded and inefficient PEs that no longer can achieve the objectives for which they were created. The culture of the PE, instigated and directed by the government, with its surplus labor and ineffective management makes survival even under private ownership in a true competitive system unlikely. These advocates assert that the funds and administrative effort spent on classic privatization and mass distribution of assets could be better devoted to creating new regulatory institutions, clarified property rights, and a tax structure under which vigorous young private sector firms could develop. These would employ new talent and capital sources including foreign investment and would be free of direct

³³ Adam Przeworski, in his analysis of transition policies, found that fear of unemployment overwhelms the effects of all other economic variables combined, and it makes people turn against the reform program. (p. 165)

government interference & in other words a true free market. They would not depend on previous state controlled institutions of the state, but would enjoy indirect encouragement and support of the government.

A secondary effect of this expansion will impact labor as new jobs are created. Private sector growth deriving from divestment of PEs, although now still seen by labor to be detrimental to its interests, will ultimately offer new opportunities that will more than counteract the redundancy which labor feared so strongly initially. It is up to the government to convince the leaders of organized labor that successful privatization not only draws investment, domestic and foreign, but in the longer term it paves the way for new entrepreneurs to establish ventures that will offer additional job possibilities.

Researchers and policy makers must develop a way to evaluate & much as Galal did & what would have happened if the large amounts of funds and human capital spent on privatization had been directed to encouraging the private sector instead. In many countries, such as the Czech Republic, it is the government's aim to hold off restructuring until the private sector grows enough to absorb current labor redundancies. Analyses on the labor impacts of prolonging restructuring efforts, on the ability of the nascent private sector to absorb workers, and on the fiscal impact of privatization efforts compared to other aggressive industrial policies needs to be available to the decision maker.

CONTROLLING THE PERCEIVED ECONOMIC IMPACT

The second area where researchers should focus is on the perceived impact of divestiture on labor. The fear of unemployment (rather than the occurrence of actual labor reductions) in these heavily over-manned industries has been one of the greatest obstacles to rapid privatization in industrialized countries, but also in the developing world where urban unemployment rates are normally high as a result of rapid influx of rural populations to the cities. Some privatization programs have suffered tremendously due to the government's inability to adequately include labor in the program design.

Governments in South Africa and elsewhere have encountered problems when they fail to enlist the support of labor leaders from the outset of consideration of future privatization. Labor resistance has embarrassed the government and undermined public trust in the ultimate intentions of the regime. Some countries, such as Tunisia, have tried experiments in providing jobs specifically for redundant workers in public works projects. Others, such as Zambia, have considered making available land in rural areas to enable displaced factory workers to return to small-scale farming; this has not, however, received enthusiastic support from those it sought to help because farming was the very occupation that factory workers were seeking to avoid when they entered the urban labor force.

In contrast, some governments have been more successful at diffusing labor resistance. For example, in Malaysia, Bumiputera workers (the Malay majority, typically less skilled than Chinese) given the option of continuing in government service or accepting the

new company's scheme have mostly accepted the move, choosing a more competitive, less secure, employment environment. One explanation is that in Malaysia, as in other developing and transition countries, the divestiture occurred during a state of crisis in public finance, and after a long public sector wage freeze. The increase to market-level wages, combined with a continued strong union position in collective bargaining inherited from the public sector, and the fact that many public enterprises in middle-income countries are relatively high-technology operations requiring employees with technical skills, means that divestiture has unequivocally improved the lot of labor.

Many countries have attempted, sometimes with the help of international donors, to avoid the problem through one-time severance payment, providing sufficient funds to allow the recipient to go into business or trade. The Galal team found that in the one case study where output fell under privatization (the privatized firm went bankrupt), the generous buy-outs meant that severed workers received greater benefits than those who remained with the firm.

The most difficult problem for the average worker in the former socialist countries, and in the developing countries as well, will be how to replace the elements of the safety net which will disappear with private ownership.

The cost of pensions is usually a subject of negotiation between the seller and the buyer in the course of completing the privatization. Workers retrained by the owners have sometimes been given a variety of options. These may include, as in the case of Malaysia, a choice of remaining on their former government pension scheme until retirement, or receiving their pensions for the period spent working for the PE in a lump sum after which they may join the pension scheme offered by the new company; variations of these plans have been proposed to adapt schemes to the age of the worker. Accepting the new pension scheme involves some risk, however, since there is no guarantee that the worker will continue to be employed if unexpected lay-offs occur or if the new employer finds his services unsatisfactory. There has been no study of the effects of these schemes.

A new and innovative form of privatization is currently being planned in Bolivia, which addresses these concerns over pension systems.. Instead of selling large PEs to private buyers, with revenue from the sale going to the government, buyers would be required to invest initially an amount equal to the value of the firm ζ in effect a doubling of the company's capital. Investors would then receive 50% of the firm's equity along with management control. The expected result would be greater productivity, creation of jobs, and eventually a rise in the living standard of the workers. The remaining 50% of the company's shares would be distributed to all Bolivians of voting age ζ but not directly. They would go to creating a number of new pension funds to be controlled by the government or by separate independent agencies. The scheme would meet three major objectives: redistribution of wealth, creating a part of the social safety net, and preventing foreign or large domestic investors from accumulating in the post-sale period a majority of a company's shares as has been the case in the past. Current intent is to offer six of the largest PEs, the oil company, the electric power grid, telecoms, the airline, some railroads, and a few heavy industries. It remains to be seen whether the scheme will prove attractive to foreign investors but it does offer a promise of combining job creation and reinforcing an important part of pension security

for labor in a country that desperately needs development; if it is successful it could become a model for many other smaller states.

FURTHER RESEARCH

1. Future research must isolate the effects of divestiture alone, as separate from other, concurrent changes in the domestic and global economic environments, changes in product demand and supply, and other changes un-related to the divestiture process.

2. As divestiture continues to be implemented in transitional countries and continues to be prescribed for the least developed countries, research must focus on the effects of privatization in those environments, as opposed to industrial or middle income countries. Given the difficulty with which the Galal study in Mexico attempted to separate divestiture effects from other rapid macro-level effects, which are perhaps more prevalent in those economies than in more developed countries, it is not clear that research will be able to effectively isolate divestiture effects in these countries. Nevertheless, a number of studies³⁴ have been published on the effects of comprehensive reform in those countries, including divestiture. While this is a beginning, there has been little follow-up regarding enterprise level effects, the distribution of net effects, and generalizations which can be applied to other similar countries.

3. Future research should include examinations of alternative methods of privatization. Increasingly privatization is used to mean everything from liberalization and commercialization to management and performance contracting to mass privatization to full divestiture. The method through which divestiture is obtained can have serious implications regarding the amount of improvement and its distribution. Additionally, analysis should focus on whether (in transition economies) privatization, or efforts targeted more to aggressive private sector growth, provides more benefits to labor.

4. Future research studies must account for and address how ~~perceived~~ impacts influence the success of a privatization scheme. In Eastern Europe, as discussed, the fear of unemployment and the accompanying loss of the social safety net can have disastrous implications for officials attempting to privatize. Research agendas should include assessments of the success of various programs which attempt to mitigate negative impacts, which attempt to include labor stakeholders in the decision making process, and which attempt to educate the public as a whole regarding the successes and failures of the privatization program. International donor organizations should develop a list of best practices which provides decision makers with a variety of possible approaches.

³⁴ For example, Gelb and Singh, 1993.

VIII. SUMMARIZED IMPLICATIONS FOR RESEARCH

A very wide array of research needs is implicit or explicit in this paper. The reader will note their diversity and can draw up his or her own list of priorities, balancing information gaps against cost and feasibility of filling them, and weighing the benefits of pushing out the analytic/intellectual envelope as compared to generating information and analytic insights aimed at improving policies and programs. The list that we suggest below gives heavy weight to cost and feasibility and to meeting the policy-maker or program designer's needs.

1. Research on economic effects and impacts of privatization is extremely thin. This is due mainly to the recency of the privatization phenomenon in developing countries, and to the difficulties of implementing convincing research in this area. Nonetheless, such research is highly important. It is essential if the idea of privatization is to win real acceptance among the large number of doubters. More narrowly, without more such research it will be hard to convince donor aid agency administrations and their legislative bosses that privatization delivers, and so is worth financing.

2. Of the many types of research that are worth doing, highest priority should be given to case studies tracing post-privatization effects on management behavior and enterprise performance, as well as on changes in labor's status. These can go hand in hand with broader country studies that describe and evaluate changes in the public enterprise sector as a whole and study the effects on public finance, on the development of competitive labor and product markets and capital markets, as well as on development of the private sector in general.

3. Similarly, contracting out, employee buyouts and internal divestiture (spinoffs) are potentially very powerful methods, useful in public enterprise sectors, central governments and municipal and provincial governments. Yet there are no good studies of their extent, effectiveness and impacts. This is shocking, not only because of the inherent privatizing potential of these methods, but because they alone address the central problem in least developed country privatization strategies: the need to *create* a private sector.

4. One of the other major obstacles to faster and better privatization is the lack of intellectual conviction among local elites that privatization is really right for them. Thinking on this question would be illuminated if there were more and better studies of the costs of the status quo. It remains astonishingly true that very few such studies have preceded the introduction of privatization programs, leaving intellectuals, officials and much of the general population wondering: why privatize?

5. The area of greatest economic significance in the next decade will be infrastructure privatization., at least in middle income countries and perhaps in some that are less developed. Its introduction can be accelerated by well-targeted research. Most of the exciting issues concern network industries (electricity, telecommunications (analyzed in Annex C), transport even postal services. Whether and how to divide these industries so as to make them competitive presents questions of great theoretical and practical interest. Related

to this are questions of the nature and sequencing of regulatory improvements. Do we really need good regulatory systems in place before privatizing monopolies like major utilities? Can regulatory arrangements be best developed as privatization unfolds, with policies tempered by experience ?

6. Research on labor impacts and in-depth assessments of safety net policies are obviously high priority. Partly this is essential to facilitate political acceptance of privatization, partly it has to be an element in anti-poverty strategies. Tracer studies following disemployed SOE workers remain few and short-term. More such studies, covering longer post-disemployment periods, would be especially helpful in framing safety net approaches.

7. Research on corporate governance issues is being undertaken in many quarters. It is the critical issue in transition economies and improvements in policy and programs might be accelerated by additional research. Whether and how insider privatization in Russia and elsewhere is being transformed by injection of new management and new corporate behavior remains uncertain. The operations and impacts on governance and income distribution of voucher funds, investment funds and other mutual-fund like arrangements that exist in the transition economies are inadequately understood.

8.. Related to the corporate governance question is the feasibility and desirability of introducing these mass privatization methods in low income countries. The question of who to sell to remains a major impediment to privatization in these countries. Mutual funds, private sector investment funds and similar institutions are being recommended as a way around this obstacle. But what low income countries need is not clearer property rights but better management of state assets. How you get this without core investors remains a burning issue.

9. Given the neglect of low income countries in existing research, the particularly large gaps in knowledge about what has happened in most of these countries, and their lagging performance in privatization up to now, this group of countries should receive special priority in future research. This country priority by itself imposes limits on the methodological sophistication that is feasible and appropriate. Data intensive methodologies such as are used in *Welfare Consequence of Selling Public Enterprises* and in the Megginson et al. research are

³⁵ The observations made by one of the commentators on the Mexico case study in *Welfare Consequences* are pertinent: **A**The final sections on the Mexico cases are perhaps the most disappointing. The conclusions are hardly surprising and seem to require only qualitative assessments of the implications of the policy measures that accompany divestiture. So what was the purpose of all those quantitative estimates, one wonders. While economists usually feel more secure with quantitative estimates, the level of generality in the case studies when they come to the policy prescription level throws into question the merits of such a long numerical journey. **(A. Galal and M. Shirley,(eds), 1994, Does Privatization Deliver? EDI, p.71).**

virtually ruled out in the low income countries. Moreover, it is not cost-effective to go down that road.³⁵

10. Extensive work is needed to test the validity of the aggregate privatization data bases that are used so widely and may be more used in future econometric research. The World Bank has financed an 8-country study in Africa, which was originally intended to be an in-depth country analysis. The researchers found that in many instances they were absorbed entirely by simple gathering of reliable transaction data. Proceeds numbers, for example, were way off from their official level. Since no reliable macroeconomic analysis can be done without more reliable basic data on numbers of transactions, actual sales proceeds, conditions of sale and reprivatizations and closings, this elementary data-grubbing should be given adequate support.

11. Whether case studies focus on a few individual enterprises or overall country privatization experience, much greater attention should be given to other non-traditional instruments, than is to other than one-by-one trade sales. The extent and effectiveness and impacts of management contracts, leases and concessions and contracting out arrangements should be essential elements in country privatization studies. The concession is of special interest because it is being widely recommended as an effective way to privatize public utilities and agricultural enterprises. (This is the creation of side-by-side agencies, one public and owning the former SOE's assets: a société d'patrimoine, the other (with mixed ownership, majority private) which operates the company). Little is known in detail about how these arrangements are working out. Research on a country or on a comparative basis on the nature and effectiveness of these arrangements would have high yield.

12. Finally, the front end of the privatization process remains in need of closer looks. The nuts and bolts of many privatization programs may not be well-designed from the strategy of enterprise selection for action, to organization of privatization agencies, to methods of evaluating assets, to methods of selling SOEs. One deficiency is apparent in most poor countries: local capacity building efforts have been perfunctory at best. There has been in general too ready an acceptance of best practices as advertized by the World Bank, but their privatization efforts are among their greatest failures. USAID could make an independent

³⁵ The observations made by one of the commentators on the Mexico case study in *Welfare Consequences* are pertinent: The final sections on the Mexico cases are perhaps the most disappointing. The conclusions are hardly surprising and seem to require only qualitative assessments of the implications of the policy measures that accompany divestiture. So what was the purpose of all those quantitative estimates, one wonders. While economists usually feel more secure with quantitative estimates, the level of generality in the case studies when they come to the policy prescription level throws into question the merits of such a long numerical journey. (A. Galal and M. Shirley, (eds), 1994, *Does Privatization Deliver?* EDI, p.71).

contribution here by reviewing how the low income world has gone about privatizing in the past decade and a half, and whether there is need for change. After all, impacts may be what counts, but without effective programs there will be no results and no impacts. The impact of research in this area would be provide USAID missions with better guidance than now exists on the state of the art. It would be useful also to client countries. And it might be packaged as a "how to" manual for practitioners.

ANNEX A

MEASUREMENT OF THE EXTENT OF PRIVATIZATION

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Good information on the extent of privatization is important for two main reasons. First, it allows us to understand whether and by how much the public-private mix is changing in various countries and regions. And second, reliable data on the extent of privatization is a prerequisite for the measurement of privatization's impact.

Two kinds of measures are in common use. The most common is numbers of transactions and their aggregate value. These have been collected for a decade or more, by such firms as Privatization International, and by international agencies, notably the World Bank.³⁶ The most exhaustive effort along these lines is summarized in a 1995 joint International Finance Corporation-World Bank paper.³⁷ This study identified 2,655 transactions in 93 countries between 1988 and 1993, with proceeds of \$271 billion. The annual number grew from 62 in 1988 to 868 in 1993. While most of the transactions (85% of the world total) took place in developing countries, their economic weight was relatively small; two thirds of the value of sales were in industrialized countries.

Sales are heavily concentrated within a few countries in each economic or regional grouping. For example, the most recent count in Subsaharan Africa (still in process), found 1600 transactions valued at \$1.9 billion. But about 70% of the sales value originated in three countries: South Africa (\$675 million in three transactions, Ghana \$475 million (mostly Ashanti Goldfields) and Nigeria (about \$200 million).

The second set of measures aims at estimating the changes in national economic structures that have resulted from privatization and liberalization. It tries to produce indicators of the extent of privatization such as changes in the share of GDP produced within the public enterprise sector, the proportion of state-held equity that has been privatized, changes in the proportion of the workforce employed in the sector, changes in subsidy flows and credit absorption ratios. Global data on such indicators has been hard to come by. The best numbers have been compiled in another recent World Bank research study.³⁸

Both sets of numbers point to one conclusion about the pace and incidence of

³⁶ See, for early examples, E. Berg and M. Shirley, *Divestiture in Developing Countries*, World Bank Discussion Papers No. 11, 1987 and Charles Vuylsteke et al, *Techniques of Privatization of State-Owned Enterprises*. World Bank Technical Papers, No. 88, 89, 90. 1988.

³⁷ Frank Sader, *Privatization of Public Enterprises and Foreign Investment in Developing Countries, 1988-1993*, Foreign Investment Advisory Service, 1995.

³⁸ Ahmed Galal and M. Shirley, *Bureaucrats in Business. The Economics and Politics of Government Ownership*, World Bank, 1995.

privatization in the past decade. Most of the privatizing in the world has occurred in the former socialist countries in Europe, the industrial countries and in Latin America. During the 13 years after 1980, 95 developing countries implemented an average of three divestitures a year. African privatization totaled about \$3 billion during 1988-93, and Asia \$20 billion, compared to \$55 billion in Latin America and \$175 billion in the industrial countries.

The economic structure indicators tell this tale better. By almost every available indicator, state enterprise sectors in low income countries were as large or larger in the early 1990s as they had been in the late 1970s and 1980: they produced somewhat greater shares of total and nonagricultural GDP, employed relatively more of the wage earning labor force, continued to run financial deficits and hence draw on budget resources through direct subsidies.³⁹

These numbers give a somewhat distorted (and understated) picture because important segments of privatization activity are not included. Excluded, for example, are small sales of under \$50,000, liquidations and all mass privatization such as dominated in Central and Eastern Europe (CEE) and the Former Soviet Union(FSU). It also excludes, because details lack, the 12,000 company sales in East Germany after 1990.

But the central point holds true & that privatization activity by available measures has been relatively slight in low income countries, that it has tended to be concentrated in few countries even in middle income regions, and that in developing countries as a whole it has wrought few structural changes in overall public-private balance.

ISSUES AND PROBLEMS

The first problem is a disconnect between definitional concepts of privatization and the empirical measures at hand. Privatization has to be understood as a continuum of changes, a series of steps that make economies more private. It means moving toward decision-making patterns based on market incentives. It occurs at the macroeconomic or institutional level, when liberalization policies are introduced, the legal/regulatory environment is made more even-handed, hard budget constraints are imposed on state sectors. At the micro level it means moving activities and decisions to private hands, in any dimension & privatizing management through contract, privatizing finance by making consumers pay more, taxpayers less, privatizing goods and service production by contracting out. It also means, of course, making ownership more private.

The trouble is that most of the effort in measuring the extent of privatization has gone into recording the number and value of transactions, defined usually as ownership transfers. And this doesn't necessarily tell you much about whether the decision system has

³⁹ Net financial transfers, however, did decline significantly in middle income countries.

become more private. These transaction tallies do not distinguish between a sale of government's 10% share in an already privately-run, majority privately-held firm and a sale of a 100% government-owned company. Nor do they distinguish sales of a part of government's ownership in a company, that remains majority publicly-owned.⁴⁰

Even the transactions data are extremely weak, especially for low income countries.

Numbers of transactions are often uncertain because the entity sold may have many component units. Industrial holding companies or hotels may be recorded as one sale when they have numerous separate component companies.

The term *Aliquidation* is imprecisely defined and used differently in different countries. Sometimes it means piecemeal sale of physical assets of a terminated company. Sometimes it is a simple legal transformation prior to sale.

Redivestiture is common, the same entity being counted as sold numerous times. The main reason is that *Buyers* do not succeed in getting the credit they need or the deal falls through for other reasons.

The data for transition economies has similar flaws. Much of the privatization that has occurred in the FSU consists of management and employee buyouts. The number of transactions in this case tells little by itself about the significance of the changes in terms of corporate governance. If there are no changes in governance and few changes in the environment of the privatized firms, then expectations on efficiency impacts would have to be tempered. So privatization data have to be supplemented by other change indicators (ejections of management teams for example) to provide genuine insight into the character of the transformations in question.

The data for developing countries are flawed also because they are very thin with respect to non-divestiture or indirect privatization. Management contracts are frequently recorded, but unevenly. Lease contracts, even in major public services, are often left out or footnoted in national transaction tallies. Contracting out, fragmentation or *peripheral* privatization (spin-offs) are rarely counted. Data on employee buyouts are sparse (except in the transition economies).

⁴⁰ The ongoing World Bank (Africa Technical Department) study of privatization in Africa analyzed 1019 transactions in 13 African countries. Only half involved total sale of assets. Governments retained shares in the 500 transactions that involved share distributions. About a third of these cases involved sale of minority interests or government retention of majority ownership.

CONCLUSIONS

It is difficult to have a true appreciation of the progress of privatization without much better basic information on the nature and real extent of the privatization actions that are being taken. One reason for the uncertain reliability and limited scope of the data available on developing country privatization is the incorporation of so many privatization programs in conditioned policy loans of the World Bank and other donors. This not only has shaped the information priorities (numbers of transactions, impact on budget deficits for example) but has given rise to a certain amount of game playing with the numbers, and frequent reluctance to be fully transparent in reporting activities.

But the sheer difficulty of tracking these transactions is probably more important a reason for the poor data base. And its limited scope is due also to developing country organizational factors: most data-gathering is done by Public Enterprise Secretariats, whose main task is classic divestiture. So they do little on management contracts, leasing, contracting out, etc.

Some clarification of concepts would strengthen any intensified information-gathering. The definition of SOEs has to rely on measurable criteria if there is to be any hope of cross-country comparison. Thus it is hard to understand the definition set out in *Bureaucrats in Business* (page 263), which includes as SOEs enterprises in which the state holds a minority of the shares if the distribution of the remaining shares would leave the government with effective control....⁶ But the authors note right away that the data they use do not fit this definition. They don't note that it would be impossible to derive criteria for control that would apply across countries. It is better to simply acknowledge the limits of these data for impact assessment and for cross country comparisons.

Perhaps the most far reaching inference from this discussion of the data on privatization/action is the doubt that data weakness casts on efforts to measure impacts. This is true for cross country analyses that, for example, regress extent of privatization to growth rates, such as appears in the Sader (1994) piece on privatization and private investment cited earlier. It is also true for time series based country studies that relate extent of privatization to growth rates or other key variables. Before results from such studies can be credible we have to be sure we know what we mean by privatization, and reasonably sure that the base data are in line with the definition.

Future research should focus more on country and firm-level case studies, which would encourage broader descriptions of the privatization process, allow assessments of the extent and impact of partial measures and indirect privatization approaches such as spin-offs and contracting out. Such studies would also encourage more focused analyses of the relationship between ownership and control in transitional and low income economies.

ANNEX B

THE POLITICAL ECONOMY OF PRIVATIZATION

POLITICAL ECONOMY OF DIVESTITURE

It has been recognized since the beginning of the movement toward privatization of State Owned Enterprises (SOE) that the political factor is as important as the economic factor in the decision on the part of any government to embark on a privatization program. Programs have failed in the last analysis because too little attention has been paid by government planners and donor agencies to meeting the political objections of vested interests and of the public in general to the risks involved in privatizing.

Bureaucrats in Business points out that, even where the economic case for privatizing is convincing and, to experts, self-evident, it must be seen to the government as politically desirable, politically feasible and politically credible. Where democratic governments are dependent on the support of interest groups to stay in power, it must first be demonstrated that privatization is possible, will result in changes that are beneficial to the mass of the voters, and that it can be managed without providing special advantages to any particular interest group. Even authoritarian governments must meet mass political objectives, although they may find it easier and more feasible to overcome them.

From the outset transparency is the critical factor; if the government is seen by the voters to be hiding its intentions by failing to keep all interests fully informed, moves toward privatization are likely to be doomed from the beginning. A second critical requirement for a successful program lies in the government's commitment to SOE reform and privatization. Without firm, clear, consistent and repeated public statements by the head of state or the Prime Minister, in which the ministers and senior bureaucrats concur, the credibility of the government's position will be undermined and popular support will be undermined.

Opposition to privatization may come from a variety of sources. Traditionally, labor has been a major opponent since privatization usually means job redundancy and reduced power for labor leaders. Other opposition groups may include bureaucrats who see their powers over state owned industries reduced, ideological groups who oppose privatization and growth of the private sector as a matter of principle and even from the existing private sector itself which fears competition from privatized firms. Opposing political parties may seize on the issue of privatization if for no other reason than it provides a convenient issue in forthcoming electoral battles.

It is essential that steps be taken prior to announcing a formal privatization program toward overcoming the objections of at least the most powerful opposition groups. Labor leaders should be engaged in dialogue at the earliest possible point so that they feel they are a part of the government's planning and that their specific interests are being considered. Labor support is more likely to be forthcoming if it can be demonstrated that there is something to be gained from privatization. Employee ownership participation plans are one important carrot that can be offered. If the government can show that even before privatization is initiated, specific plans are under way or will be implemented without bias at the earliest possible moment to deal with redundancy through cash compensation for job loss or retraining programs, labor's fear of privatization may be reduced; government from the outset must show a human face. Dialogue with the private sector can also be profitable in allaying opposition from this quarter if the government can illustrate that the experience of business men is being considered as privatization plans are being drawn up.

But probably the most important step the government can take in seeking popular support is to initiate a comprehensive public awareness program to explain the concept of privatization and the advantages to be expected from it. Where well planned campaigns using all available media, such as that launched in Jamaica, have been used they have been successful in formulating positive public opinion. There may be situations, of course, where the strength and organization of opponents can lead to extremes of costly strikes, as in Bangladesh and Sri Lanka, and even widespread civil disobedience. In such cases the government may conclude that the political and social costs of forcing SOE reform are simply not worth the economic benefits to be derived from it in the short term and so will back away from any action. A further factor may be that the government finds that the cost of redundancy payments will be much higher than appeared while the potential financial returns from privatization will be considerably less than planned; such was the case when the pace of privatization was slowed in Ghana.

Marshaling political support for privatizing depends also on the methods the government proposes to use for the transactions. The government's objectives may be rapid disposal of the enterprises by direct sale with immediate financial returns to the treasury or mass privatization by coupon distribution giving ownership to a broad segment of the public. This later method, while cumbersome and often complicated, gives the impression of involving the people as a whole in the privatization process and provides immediate evident and tangible benefits, at least initially. This tends to blunt the opposition arguments that the regime is disposing of public property to private (sometimes foreign) ownership or reserving the benefits of privatization to some favored cronies able to take the disadvantage of the sales. The highly complex negotiations for a sale between a single buyer, or a consortium of buyers and representatives of the government inevitably involve a degree of secrecy that leaves the government open to attack for lack of transparency.

To maintain political support over the lengthy period of preparation before privatization actually begins, it is crucial that government publicly keep its promises to the public. The process of divestment should be as rapid as circumstances permit and detailed reports on progress should be made periodically by prominent spokespersons or even by the head of state. The best demonstration of the benefits of privatization is a successful sale so that entities which offer the best prospect for immediate sale should be put on the bloc first simply to maintain public interest and government credibility. If policy reforms in the financial or regulatory structures are to be made as a concomitant to privatizing, opportunity to discuss these should be a part of the publicity effort. The way to continuing political support lies in the consistency of government's determination to privatize in the face of opposition pressure from whatever sector and in the ability of the ruling party to organize coalitions of its supporters to meet the opposition's criticisms of its privatization policies

If the political pressure becomes too strong, the government can resort to indirect privatization as a temporary measure. This involves such actions as management contracting or leasing to restore faltering SOE's in anticipation of later sale, spinning off of parts of large SOE's into separate operations or other devices. These may be particularly appropriate to defend against charges that the government is losing control of significant sections of the economy (particularly in the case of large public entities) to foreigners acting jointly with wealthy local citizens. Alternatively partial sales may be used, such as sale of minority tranches of shares on the local market while the government retains majority control, or the provision of a golden share in any sale. Such protection may act as a deterrent to foreign investors because of the implied threat of later government intervention, but this may be outweighed by the political reassurance indirect privatization offers to groups opposed to any privatization whatever.

In French speaking Africa, management contracting has recently been used by major French firms with the help of the government in Paris as a political instrument to maintain French influence in former French colonies. Aeroports de Paris now has contracts to manage five airports in Cameroon and Gabon. In Ivory Coast, the French contracting firm Bouygues has constructed an independent electrical generating system using gas turbines and sought, unsuccessfully, to secure a monopoly contract for offshore gas wells for use as a fuel source. These monopoly contracts have been let without transparency in bidding competition because local governments were unable or unwilling to resist French government pressure to grant monopoly concessions; protests by potential non-French contractors were ignored.

In at least three recent cases, contemplated privatization programs have been delayed, abandoned or put on hold as a result of domestic political objections. In South Africa, elements of the national trade union organization have staged wildcat strikes to protest privatization planned in the telecommunications and transport sectors because of fears of job loss or job discrimination. The government promptly backed away from any immediate privatization, as tension between the African National Congress and its long time ally, the trade union movement, grew. In Haiti, the government planned important transactions in the country's largest and most strategic industries (power, telecommunications, ports and airports, as well as banks). The preparatory work which had been underway has now been put on hold, however, because the government's determination has faltered as a result of labor's fears of redundancy and by private sector leaders fearing that control would pass from the privatized firms to foreign investors; the decision to proceed will rest, in part, on the result of forthcoming elections. In Zimbabwe, privatization is being impeded by the failure of the government to convince senior black managers in local investment houses that it will not serve to further entrench control of the economy by white minority investors, especially those from South Africa.

THE POLITICS OF THE ECONOMIC AND REGULATORY ENVIRONMENT

Preparation for a successful privatization exercise involves more than ensuring public support for the divestment of SOEs. Steps may have to be taken to assure potential buyers of a favorable economic environment for the private sector as a whole. These may involve restructuring of the financial system to provide access to credit stability and elasticity in foreign exchange transactions and confidence that a level playing field will exist. Above all, if foreign investors are expected to play an active role as buyers of SOEs, long-term measures to control inflation are essential. No major outside investor will be interested in making a substantial commitment if he is not convinced that his capital can be withdrawn at or near the rate of exchange at which it was invested.

If the sale of major and strategic industries is part of the government's plan in privatizing, development of a detailed regulatory system will be needed to prevent monopoly exploitation after privatizing. Few developing countries have extensive experience in creating regulatory structures and external advice may be needed before final decisions are made to put on the market utilities or transportation facilities. A regulatory regime acceptable to the financial sector will also be needed if the sale of shares on a fledgling stock market is likely to be used.

A substantial part of the decisions necessary for restructuring and/or regulating the economy will have major political implications and repercussions. The government should be aware of the risks it is assuming. For example, mass privatization may be one of the government's political goals but it may conflict with the needs of the private sector for new management skills, imported technology, marketing skills and sophisticated financial institutions and practices without which efficient privatized industry cannot be achieved. Strategic industries such as public utilities and communications may be particularly affected since they require foreign investment and up-to-date technology. This clash of political and economic objectives may result in a confused privatization plan and the appearance of foot-dragging on the part of government policy makers.

Profound changes in the institutional framework of the economy can have serious effects on the social welfare of the mass of the population. Where workers have been accustomed to depending on SOEs for a broad range of social services such as hospitals, schools, day-care and even housing which are unlikely to be provided by privatized industries, the elimination of the ancillary services may provoke a serious political reaction against the regime in power, providing fuel for the arguments of the opposition that, by privatizing, the government is ignoring the needs of the people.

The degree to which institutional change should precede privatization or be undertaken as privatization proceeds is a matter of debate. The consensus appears to be that while, ideally, as much change as is feasible should be undertaken before large scale privatization begins, there will never be enough time for full preparation. At the very least, however, it is desirable that the government should advocate an awareness of the changes needed. It should be seen to be taking initial steps to replace the benefits lost by privatization if continued voter support is to be maintained.

THE CHANGING ROLE OF THE DONORS

Support of privatization as a part of economic liberalization and structural adjustment has been an essential element of donor policy for some years. Concentration on organization, mechanics and techniques has occupied much of the donor efforts at times with excellent results, especially in transition economies. But in developing countries too little time has been devoted to answering the question, is the country ready for privatization or should a longer period of preparation be undertaken before embarking on specific divestment projects.

A more thorough review of the economic and political climate and environment might have avoided some the mistakes, hesitations, and failures seen in countries such as Kenya and Zambia. Privatization advice based on a more detailed knowledge of the government's political strengths and weaknesses and popular faith in the government's decision making and its capabilities to enforce its decisions might have yielded better advice or suggested a different course of action. Better estimates of the private sector, its business and financial skill levels, and its relationship to the political structure and leadership might have led to better estimates of the probable success of privatization. More time spent on assessing the real nature and degree of the government's determination to privatize might have brought a more accurate answer to the question of whether the political leadership was responding to a genuine and understood need to privatize or just to donor pressure and financial incentives.

As privatizing proceeds, donor attention should shift from preparation of the economy to advice on how best to meet post-privatization problems. Donor funds should be shifted from direct assistance to government agencies for establishing and organizing privatization mechanisms (and even the financing of deals) to helping to create a more level playing field for the private sector of which the newly privatized firms will now be a part. Care must be taken, however, that donor activities do not discourage or conflict with private sector management and investment. At the post privatization stage, relations between the government and former SOEs may require help, particularly in cases of payment default. Donor help at this point will continue to be needed in a number of ways but it should be carefully and diplomatically managed since relations with SOEs will be governed by regulatory codes.

Further research is needed at the preparation stage. On a case-by-case basis, what changes are needed in the economy, in the political structure, and in the private sector to make privatization as effective as possible? How best to bring about these changes without upsetting the political apple cart and how best to help the government deal with the social effects of SOE divestment on the public as a whole. A more thorough understanding of the economic situation in which privatization will take place and of the current and potential roles of the private sector will pay real dividends both to the political leadership and ultimately to the donors as well.

The author of a recent IFC study (Donaldson, 1995) has written, "All privatization is politics." This may be only a slight exaggeration; without finding solutions to the underlying problem of conflicting political forces and vested interests privatization will at best be halting and at worst simply abandoned as a tool of development.

ISSUES AND CONCLUSIONS

(1) The issue of whether and to what degree an economy is prepared for successful privatization remains a matter of discussion. Some experts have maintained that the government must, prior to privatization, make the tough economic policy decisions necessary to embrace a turn to the free market and make clear that it is prepared to implement them. Others have argued that if such a program is not fully in place before embarking on privatization, the program will be held up indefinitely and any advantages to be gained may be lost. What is clear, however, that they must be made sooner or later if private sector development is to proceed. The very fact that liberalization is seen to be part of the government's long term program will substantially increase the chances of advantageous sales of SOEs since foreign investors, in particular, will be hesitant to come in unless the government gives evidence of the seriousness of its intent to ensure a level playing field for the private entrepreneur. All of these decisions (especially those dealing with control of prices) entail some degree of political risk; the more the government is dependent on special interest groups and coalitions to remain in power, the greater the danger of defeat by forces opposing divestment.

Lanza (1995) makes the point that the financial sector plays a critical role in improving efficiency of production and redistribution of state owned assets. Without an effective financial structure in private hands, privatization may, at least in the short term, be a waste of effort. Official encouragement of financial sector growth to demonstrate the opportunity for popular participation in transforming the

economy is an essential, if also a politically risky, course for the government to pursue. Chile is frequently cited as an example of the success which can be achieved by a determined political regime following consistent policies of reducing the scope of the state owned sector, while simultaneously supporting financial sector reform.

(2) The government's goal in privatizing should be clarified before large scale divestment is undertaken. Which political constituency, for example, is the government's major concern - the general public, special interest groups such as labor, or the local private sector, opposition parties, or strategic (often foreign) investors? In the case of Mexico, for example, privatization was aimed chiefly at investors; in Russia the concern was the workers and the management of the firms being sold; in the Czech Republic it was redistribution of assets to the general public by mass vouchers (Donaldson, 1995). The government's decision as to what group the privatization program is directed will play a major role in determining not only the form, but the scale of privatization. Where the government, for political reasons, seeks a compromise among conflicting interest groups, a confused and ultimately unsatisfactory program results. The issue here is how to insure that the political leaders have given adequate consideration to all possible approaches before committing themselves publicly to a particular strategy of privatization and how solid is support within the government for a strategy once adopted.

(3) The continuing role of government in the post privatization period remains an unsettled issue. In many cases, while ostensibly embracing privatization, the government remains loath to surrender control fully to private ownership. The temptation to interfere with management decisions remains strong. Political motives may lead the government to retain a sufficient number of shares in partial privatization to insure representation on the board of a privatized enterprise. Alternatively, some degree of control may be retained by the provision for a golden share, as in British privatizations, which can be exercised at critical points of management decision. But even the prospect of government interference reduces investor confidence and reduces management initiative. In many cases retaining the right to intervention has a different political goal; it becomes the government's defense against critics who oppose the loss of ownership of the "people's patrimony".

(4) The current trend to privatization of large public utilities, such as telecommunications, generation and distribution of electric power, and transportation facilities poses new and highly complex problems for governments since it requires the creation and administration of regulatory regimes. Substitution of direct government control of these large (and politically sensitive) monopolies by private ownership implies the loss of political patronage, jobs, direction of services to politically favored areas of the country, and the perquisites of management enjoyed by senior civil servants. At the same time governments are fully aware that the public demand for extension of the services of these utilities is growing very rapidly and that the political consequences of failure to meet this demand could be very serious. Caught between these conflicting political considerations governments are now being forced into unfamiliar territory of rule making which, no matter how skillfully done, will inevitably result in political attacks from the general public as well as from the private sector. Initial mistakes will assuredly be made; the best politicians can do is to weather the storm until enough experience is gained to satisfy both the public demand for universal service and the profit requirements of the operators who provide the services.

Because privatization is an essential tool in a political revolution designed to reduce the role of the state in national economic activity, politics will continue to play an important part in the privatizing process. The maturing of privatization from the stage of divestment of single state owned enterprises to the

sale of large scale national utilities and transportation networks will not reduce the political element inherent in privatization, but it will change the nature of that element. Now a panoply of political interests in the society as a whole will be affected, replacing the individual interests involved in one-off sales. Governments will no longer be engaged simply in comparatively small scale divestment, but will become the regulators of enterprises which affect increasingly large sectors of the population at every social level. Donor assistance, more perhaps in the form of technical assistance than direct financial support, will continue to be needed to equip civil servants to play the new role of regulators so that the maximum public benefits of these privatizations can be assured.

(5) Use of the proceeds from privatizations remains a contentious political issue. Governments may take the stance that revenues from privatization sales simply become part of the Treasury's resources for meeting the general expenses of government or for reducing government loans. In other instances, income from privatization has been devoted to the expenditures occurred in the financing of divestment (such as privatization agencies as in the case of Egypt). The government may also be under political pressure to use the income from privatizing to initiate or extend coverage by the social safety net (as in the case of the proposed Bolivian experiment to establish national pension funds). Similar pressures may be exerted to use the proceeds from privatizing to cover the social costs of divestment, such as retraining schemes or the payment of separation grants to displaced workers. Whatever the uses to which proceeds are diverted, it becomes politically important that the government be publicly seen to be concerned about the effect of reducing the state sector on the most vulnerable sections of society. Members of the political elite or those close to government must not be seen to be benefitting personally from privatization sales.

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ANNEX C

**REGULATION IN THE PRIVATIZATION
OF TELECOMMUNICATIONS**

The most active field of privatization over the next two decades in the developing countries will be the privatization and commercialization of telecommunications. The demand for telephone service in Latin America, Africa, and Eastern Europe is almost insatiable. Indeed, more than 50% of the world's population have never used a telephone. It is estimated that more than two-thirds of the \$60 billion a year likely to be devoted to expanding telephone systems will be spent in the developing world where the number of phone lines will increase over 11% a year between now and the year 2000, as compared to 3.7% in industrialized countries. Economic development is closely connected to the growth in the number of available telephone links.

The rush to satisfy telecommunications demand has led to a rash of new privatizations both by direct sales to foreign operators of national telephone networks in some countries, by indirect privatization by joint ventures between governments and foreign operators, or by build-own-operate agreements between makers of communication equipment and telecommunications ministries. Currently, 26 privatizations of national phone networks in emerging markets are scheduled and licenses for completely new cellular operations are proceeding at a rapid pace in Latin America and Asia. India, for example is proposing to auction two cellular licenses for each of the 20 operating regions of the Indian network.

Reform of telecoms in developing countries is not simply a matter of selling the existing network to the highest (usually foreign) bidder. Traditionally the telephone network has been government owned and operated, usually through a Ministry of Posts, Telegraphs, and Telephones (PTT) which was at the same time the provider of services as well as the regulator of prices and services to the consumer. Most state-owned networks suffered from operating and management inefficiency, poor service, limited scope, and outdated technologies. They were often subject to political pressures to maintain low rates, misdirected or inconsistent government objectives, and a variety of restrictions and conditions resulting from the fact that telecoms was a public sector enterprise. Transformation of a Ministry into a commercial firm involves at least two stages; the Ministry becomes a commercialized SOE which is then offered for sale to private owners. Uganda, for example, is currently passing legislation to initiate this process and has advertised for bids from international firms to take control of the national telephone operation with plans for rapid and substantial increase in service to both domestic and international subscribers. State ownership may cease at the time of sale but government responsibility remains in the form of regulatory supervision.

The goals of the governments in privatizing are, among others, to find new sources of capital for expansion of the network ultimately to the point of universal service and to modernize the entire system with the introduction of contemporary technology that could only be gained through partnerships with the multi-lateral giants of the industry. Nevertheless, however attractive a new communications system may be, governments continue to be reluctant to lose control of the strategically important national communications facilities. Privatization involves a political threat to the government's position in that trade unions fear loss of jobs (as is the case at the case in South Africa at the moment) and nationalist factions bitterly object to what they regarded as a threat from foreign capitalist domination. To counterbalance these disadvantages, governments are aware that the rewards are delivery of new services throughout the country, the prospect of increased revenues, and the guarantee that the nation would not be left behind in the worldwide revolution in telecommunications services. The long term economic gains and the social equity to be achieved by an enhanced communications system are considerations that cannot be ignored. Particularly for the rural areas the prospect of a connection to the outside world is of immense social and economic importance; the success of the "telephone shops" in remote South African villages is only one

example proving the point.

Governments everywhere have begun to realize that the key to accepting foreign ownership and direction of the telecommunications system lies in the capability of the government to devise a modern regulatory system which would provide sufficient incentive and assurance to foreign capital that its investment would be secure and profitable, while at the same time protecting consumers from exploitation by regulating costs and the extent and quality of service. This comprehensive action, particularly in the case of telecoms, will, in most developing countries, be a new experience for the politicians and the bureaucrats. In the past, where government owned the networks, direct regulation was comparatively simple; government decided on certain price levels and service regulations (taking into account in the process the host of political and interest group considerations found to be desirable) and gave appropriate instructions to the system managers. The fact that overregulation may have stifled management initiatives and impeded efficiency could be largely disregarded within the state owned enterprise structure.

With the transfer of network ownership to private hands, however, the problem of regulation becomes infinitely more complex. No longer can domestic telephone rates be used to subsidize government functions and services, and the heavy surcharges levied on international calling which had been a major source of hard currency revenues are no longer available since they are unacceptable to multinational operators. The complex new technologies required by modern telecom systems and the demand that the network now produce profit levels expected by foreign investors means that civil servants must not only acquire new skills in creating regulations, but also a perspective on how business is done in the context of international operations. Moreover, when a competitive element is introduced as part of the demonopolization of the structure of communications, the government must learn how to regulate competition in long distance rates and value added in domestic calling markets. If the privatized communications network financed by foreign investors is allowed to engage in monopoly pricing much of the advantage of privatization will be lost from the consumer point of view.

The world-wide eagerness to acquire additional modern communications facilities means that there is a competitive market for available investment capital as well as for equipment. With opportunities in telecom expansion spread world-wide, investors can afford to be choosy as to where their capital will be placed. A government which seeks to overregulate investment in expanding service will find that the number of potential overseas partners will be seriously diminished and that finding new partners will be lengthy and difficult. Governments are rapidly discovering, moreover, that honesty is the best policy in dealing with telecoms investors. A World Bank loan to Kenya to achieve greater efficiency in the operation of the telephone system, for example, was seriously endangered when the lender found that the government was only pretending to lay-off the thousands of workers required to meet the terms of the loans. Given the heavy commitment needed in telecoms deals, investors have to be convinced that the government is serious in its long range determination to modernize within a free market. In 1994, Venezuela risked a pull-out by American and European investors of a \$1.8 billion commitment by introducing foreign exchange controls preventing payment to hard currency debt shareholders and renegeing on an agreement to allow an increase in phone rates. While agreement was finally reached, these actions prompted investors to hesitate in concluding negotiations with surrounding countries. The nature of telecommunications investment in infrastructure and equipment requires a long-haul decision by foreign capital to go in the first instance; money spent is not easily retrieved or withdrawn.

Achieving a satisfactory regulatory structure is particularly difficult in the case of any utility

but perhaps even more so where telephone services in developing countries are concerned. There is little question of the real demand for services in rural areas, nor that the presence of the service will be a factor in encouraging local development. But where these areas are sparsely settled, there are not enough subscribers to warrant investment in the necessary equipment to extend the network and hence little incentive for the private sector without either subsidized pricing or other government intervention to meet at least part of the cost of providing the service. Without these, service may be limited to those who can afford to pay for it while the poorest section of the population in rural areas will likely go without. It is at this point where the skills of those administering the regulative regime are put to the real test. Can a formula be worked out so that the privatized company can be encouraged to expand the network to unprofitable areas as a matter of social equity while at the same time maintaining a price structure that will be fair in areas of consumer concentration as well as to provide the necessary margin of profit?

It is this type of fundamental policy decision that regulators in developing countries are least able to make given their inexperience and lack of skilled manpower in the regulatory field. Simply to maintain the normal day-to-day regulative functions of monitoring compliance with existing rules will tax the capabilities of the regulators in emerging countries. Inevitably they will be forced to rely for advice in regulating on one of the interested parties (i.e., the private sector operator of the system) unless some source of advisory assistance is available. Ideally, from the point of view of both parties, a fully developed regulatory regime should be in place before the foreign investor comes in so that both the government and the investor are operating on a relatively level playing field. But neither party wants to wait for this to happen and, in any case, it is probably impossible to foresee all or many of the areas in which regulation may be needed as modernization progresses.

Privatization of telecoms does not, then, mean the elimination of governments' role in developing an efficient mass communications system. Government will lose ownership of the network; this initial step is unavoidable if the desired goals of the system are to be met. When ownership goes, the regulatory function assumes a new and critical role in determining success in the telecommunications revolution. But this is the very point at which the government has had little or no experience. Meeting the conflicting requirements of a technology-based private sector telecom system for efficiency and profit and also for social distributional justice and service to the public will need regulators with technical skills and devotion to public service — a combination all too rare in developing countries.

ISSUE

Privatization of large public utilities will be a growing preoccupation of governments in developing countries so that they may become part of the global technological revolution. But this type of privatization poses substantially different problems from the comparatively simple one-off sales that have characterized most of the privatization programs outside Eastern Europe and the CIS countries. It poses the double problem of finding buyers who can meet the needs of service expansion and efficient system operation while at the same time changing ownership to government regulation in the public interest of these utilities. Most governments will be unable to construct and administer complex regulatory regimes without outside technical assistance. To secure the advice of potential buyers, governments will in many cases turn to the donor community for disinterested advice and financial help to devise a regulatory structure that meets the private sector requirement of profitable operation and the political responsibility of

the public demand for availability and service at affordable prices.

ANNEX D

**THE LITERATURE ON PRIVATIZATION, 1992-1995
SELECTED REFERENCES**

Since the early 1990s there has been an explosion of writing on privatization. Scores of books appear each year as well as hundreds of articles and dozens of conference and discussion papers. Given the vast volume of output, and its accelerated flow in the mid-1990s, no bibliography can pretend to be comprehensive and up to date – at least not for more than a few months.

Only a few selection rules have determined the choice of references listed below. We are interested in the developing and transitional economies, so very little is included on the privatization experience of the industrialized world. We had to be selective in dealing with the general literature on economic reform; privatization is the focus. Hence, some relevant and important analytic pieces may have been excluded. No newspaper articles are included, which entails omission of much useful material – of the kind, for example, that often appears in lead stories in *The Wall Street Journal* or the *Financial Times*. Also, we made the distressingly unhistorical decision to exclude all writing that appeared prior to 1992, with very few exceptions. The rare exceptions cover particularly neglected functional or regional issues.

The regional composition of the references is heavily weighted in favor of the Former Soviet Union and East and Central Europe. This of course is simply a reflection of the literature, which is increasingly dominated by the transition economies. Many useful references dealing with problems of the transition economies therefore had to be neglected, while we were more open to writings on the other regions.

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