Implementing Privatization Programs: Key Issues and Lessons Learned

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I. INTRODUCTION

While numerous countries throughout the developing world have engaged in privatization over the past 30 years, since the end of the Cold War and the spread of capitalism throughout the former Eastern Bloc, privatization has once again come to the forefront of the development experience. As states seek to scale back their involvement in the economic sphere to allow the private sector to become the dominant player in the marketplace, privatization has emerged as the method of choice for accomplishing this task. Yet, privatization, for all its perceived benefits, comes with numerous challenges for a developing country. The change from state to private ownership brings with it a period of change and dislocation. In order for a country to successfully reap the benefits of privatization, it must be aware of the potential obstacles and have a comprehensive plan for addressing them.

Privatization or divestiture of state-owned assets entails the transfer of ownership rights from the public sector to the private sector.[1] During privatization, the bureaucrats and politicians who run state-owned enterprises (SOEs) are replaced by private owners and managers. Typically, governments seek privatization of SOEs in order to achieve one or more of the following objectives: higher allocative and productive efficiency, strengthened role of the private sector in the economy, improved financial health of the public sector, and the freeing of government resources for other areas of concern. Privatization tends to promote profit-maximizing behavior and leads to a reduction in political or bureaucratic intervention, thereby reflecting a change in firm goals from the pursuit of political objectives to the pursuit of profit-oriented objectives. Additionally, privatization tends to promote greater managerial autonomy and improved motivation and productivity through the provision of incentives.

Privatization can indeed provide the numerous benefits sought by the government in addition to providing benefits for the newly privatized firm. An appropriate enabling environment, consisting of specific institutional and macroeconomic factors, is necessary to garner these rewards. Legal and regulatory frameworks that encourage competition and free entry into the marketplace are essential institutional ingredients to allow privatization to succeed. Macroeconomic factors such as a competitive market structure, a well-developed financial sector and capital markets, and a system of property rights are also key to the privatization process.

The first section of this paper defines privatization, discusses the sale process, and outlines the benefits of privatization. The second section illustrates the key institutional and macroeconomic components of enabling environments that are conducive to successful privatization programs. The third section discusses key privatization and post-privatization issues, including employment and the evolving roles of the state and private sector. The final section provides a summary of the lessons learned from privatization.

[1] In this paper, privatization denotes the sale of at least 51 percent of shares in a state-owned enterprise, with the controlling share in the hands of the private sector. Furthermore, the type of privatization discussed in this paper generally pertains to large-scale industries, utilities, or manufacturing.

II. THE PRIVATIZATION PROCESS

As mentioned earlier, privatization entails the transfer of state-owned assets to the private sector. This process implies not only a change of ownership from the public sector to the private sector but also a change in firm objectives and behavior. In a survey of newly privatized firms in Chile, Malaysia, Mexico, and the United Kingdom, it was found that privatization led to a greater emphasis on commercial objectives by newly privatized firms; increased managerial autonomy, especially over finance, investment, and personnel issues; and improved incentives for managers and workers based on individual performance and firm profitability (Galal et al. 1994). The following section discusses this ownership change in more detail, as well as the different methods of privatizing SOEs and the benefits that can be accrued from privatization.

The Sale Process

While the focus of this paper is on the issues arising from privatization, there are several aspects relating to the process of privatization that may have a very direct bearing on the future success of the endeavor. The first step in the process is securing political support for privatization and ensuring that the process is transparent. Otherwise, governments will be forced to spend their time and resources not on carrying out the most effective program, but rather on fending off opposition from those groups that benefited from the old system and those concerned about potentially deleterious outcomes. Consequently, the government may need to carry out a public awareness campaign during the initial stages of the process to increase public understanding of privatization. In the case of Romania, for example, USAID sponsored a campaign to engage the populace in the debate and provide information on the direction of economic reform (USAID 1995).

Another crucial aspect in terms of the success of the firm's profitability and managerial achievement, is to whom the state-owned enterprise gets sold. Because of the difficulties arising from the legacy of state ownership, the new owners face a task more akin to starting a new business (finding new markets, dealing with established global competition, finding skilled workers and managers), than the purchasing of a profitable private enterprise (Frydman et al. 1997). These challenges require skills that are more likely to be found in certain buyers than others.

For political reasons, state-owned enterprises being put up for sale are often offered first to the firm's employees whether they are workers or managers. Several studies, and in particular the one done by Frydman et al. (1997), have found that "privatised firms with outsider (non-manager and non-worker) owners are better able to remove the cost inefficiencies inherited from their past. In general, we find that firms with outsider owners significantly outperform the firms with insider owners on most performance measures, and that the employees are particularly ineffective owners (indeed less effective than the state)."[2] This study and others suggest that long-term profitability of a firm may be at odds with the political desire to keep the enterprise in the hands of workers or nationals. As will be seen later in this paper, newly privatized firms face numerous challenges and are by no means assured of surviving in a more liberalized economy

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[2] See, for example, Korsun and Murrell 1995; Evans-Clock and Samorodov 1998; or Megginson and Netter 1998.

even with the best managers and owners. Governments must consider the repercussions of imposing the added burden of owners tied to the "old way" of doing things to these firms if they are truly concerned about the firms' survival.

Change in Ownership

The transfer of ownership rights can be either full or partial. Under full divestiture, the government maintains no stake in the enterprise and managerial control of the enterprise is transferred to the private sector. By contrast, under partial divestiture, the government maintains a minority share in the privatized firms. The relinquishing of state control is the primary objective in the divestiture process. If partial divestiture occurs and the government is allowed to exercise managerial control of the firm, the transaction may not appear to be legitimate. In some cases however, partial divestiture may be a necessary first step towards full privatization. Partial divestiture can help determine the fair price of the firm in an uncertain, but fairly well developed, market environment. Additionally, partial divestiture can be used as a political compromise to reassure the public that national interests are not being sold off to the highest bidder without considering strategic interests.

The potential new owners can be grouped into four categories: outsider, insider, foreign, and state (Frydman et al. 1997). Outsider owners generally witness better revenue growth than SOEs and tend to shed employment at much lower rates than SOEs. Insider owners can either be managers or employees of the firm. Having managers or employees as owners of newly privatized firms is generally not recommended despite the possible political benefits of being able to head off opposition, as these firms tend to exhibit lower productivity growth rates and higher operating costs than many state-owned or private companies. Foreign owners may bring in foreign exchange that can be used to reduce external debt, as well as expertise and technology, but future repatriation of profits may be cause for concern. This could lead to increased political opposition against privatization and thwart future divestiture programs. The state could retain partial ownership, at least in the interim, to help thwart political opposition to the transaction and help determine a fair market price for the full divestiture of the firm (Frydman et al. 1997).

As outside owners are, in most cases, the optimal choice for a firm being privatized, the state has to determine ways to best attract these investors. To a large extent their concerns regarding the SOEs are based on the same concerns they would have regarding any firm they were contemplating purchasing: profitability, perceived market share, and efficiency. Firms that are to be privatized face an additional hurdle, namely the level of state involvement or retention of shares after privatization. Some investors may perceive partial government ownership as a guarantee of future profits or at least a bailout in case of firm failure.[3] Most legitimate investors will be worried that state involvement may result in the government influencing decision-making in order to score political points rather than for the best interest of the firm. This suggests that while retaining shares in a privatized firm may be necessary for a variety of reasons, the government must make a clear and credible commitment to resist influencing the firms'

[3] This emphasizes the need for governments to quickly implement market oriented reforms and rid firms of soft budget constraint expectations in order to remove this distortion. This topic is dealt with in more detail in the section on the evolving role of the state and the private sector.

decision-making if it wishes to attract investors looking to contribute to the economy and not merely seeking to extract rents.

Restructuring

Rarely are state-owned firms competitive, either in terms of production structure or output, with the rest of the world. In order to modernize SOEs and make them attractive to the private sector, most SOEs go through a period of restructuring. Restructuring refers to the laying off of workers, making new investments, reforming the internal management structure, or reducing enterprise debt that accompanies privatization (Galal et al. 1994). While most scholars and practitioners agree that the sale of state-owned enterprises necessitates firm level restructuring, the fundamental issue is whether restructuring of any sort is necessary, and if so, when it should occur—before or after the sale.[4] The answer to this question lies in making the decision as to whether or not the government has a comparative advantage at restructuring. That is, the government must determine if the cost of restructuring will significantly raise the sale price to not only cover the cost of the restructuring but to also produce profits arising from the restructuring.

Another important consideration in making the decision about whether or not to restructure relates to public perception and political legitimacy of the new owners. For example, if restructuring requires laying off workers, it might be best for the government to lay them off prior to the sale so that the new owners would not have to face public or political opposition. Lastly, in certain cases, firms will have to be liquidated rather than sold. The firms to be liquidated are usually characterized as unproductive, inefficient, and costly to operate. The government has a difficult task of determining which firms should be liquidated since many SOEs tend to exhibit these characteristics. Nevertheless, the government must determine which procedure—restructuring or liquidation—is more cost efficient in these cases.

Methods of Privatization

The transfer of state-owned assets to the private sector can occur through a variety of methods: mass (voucher) privatization, direct sales, public offerings, mixed sales, and concessions (López-Calva 1998). Mass privatization through vouchers entails the public distribution of firm shares to citizens through vouchers that can be exchanged for stocks during the bidding process. This method was used across Central and Eastern Europe in the early stages of the transition from state to market-based economies, and found success in relatively few countries such as Lithuania and Estonia. The advantages of this method are that it is politically acceptable because ownership is public and it helps the development of capital markets. The disadvantages are numerous, including significantly reducing proceeds to government, reducing attractiveness to foreign investors, and potentially undermining corporate governance after privatization due to certain economically inefficient advantages given to insiders. That is, the diffuse ownership base created through voucher privatization can allow managers to carry on as before the privatization because they continue to maintain greater stockholder control than the large number of citizens who own a relatively small share in the company, thereby making fundamental change difficult.

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[4] See, for example, Galal et al. 1994; Korsun and Murrell 1995; Sheshinski and López-Calva 1999; or Kikeri 1998.

Generally, the mass voucher privatization method is not recommended unless political acceptability is a major constraint to privatization.

Direct sales to strategic investors can occur through a competitive bidding process or private negotiations on a case-by-case review of potential buyers by the privatization agency. This method often produces higher government revenues through competitive bidding and is also cheaper to run than public offerings. Direct sales limit the possibility of broad public ownership and as they do not require the issuance or trading of shares, direct sales do little to spur capital market development.

Public offerings consist of the sale of the company to the public in the stock exchange or a similarly organized market. This method's advantages include a transparent process, an impetus for capital market development, the creation of a broad ownership base, and attractiveness to foreign investors. The main disadvantage of public offerings is the high transaction cost involved. The sales price of the firms to be privatized need to be low during the initial offering in order to attract potential buyers.

Mixed sales are the most common method of privatization in developing countries. This type of sale entails the direct sale of the firm to strategic investors, followed by a public offering, usually six to 12 months after the direct sale. The advantage of this method is that the sale goes to investors with the potential to make the firm profitable before it goes for public offering. This method also helps the development of local capital markets. The disadvantage, similar to typical public offerings, is cost. The costs associated with this method are higher than typical public offerings or direct sales. This method is best recommended for large firms because the demand for control and ownership of the firm has to be big enough to justify its cost.

The final method of privatizing state-owned assets is through concessions. This method is used particularly in the cases of natural monopolies such as infrastructure development and the provision of public services. Certain schemes are necessary in these cases to protect consumers from exorbitant costs while at the same time allowing investors in these monopolies to maximize their returns. The concession can be for the rights to build operating facilities and provide the goods and services to the public for a specific period of time.

Benefits of Privatization

Typically, governments engage in the privatization of SOEs in order to achieve higher allocative and productive efficiency, a strengthened role of private sector in the economy, improved financial health of the public sector, and/or the freeing of government resources for addressing other areas of concern (Sheshinski and López-Calva 1999).

Evidence confirms that privatization can reap numerous benefits. These include:

- For privatized firms, higher profitability and enhanced performance

- Increased efficiency and higher productivity because privatization encourages competition among firms

- Improved financial health of the public sector through reduced deficits and debt; privatization of SOEs provides governments with needed revenue

- Reduced government subsidies to former SOEs

- Developed financial sector as evidenced by increasing stock market capitalization

- Higher employment in the long term because privatized firms are able to make higher profits than SOEs and can afford to hire more workers

- Expanded resources for the state to address other endeavors such as the provision of social safety nets, implementation of judicial reforms, or building of administrative capacity

III. ENABLING ENVIRONMENT

An appropriate environment is necessary for privatization to be beneficial. The enabling environment, referring to the institutional and macroeconomic contexts of a given country, shapes how privatization proceeds and whether or not privatization works in a given country.

Institutional Context

In order for the technical aspects of privatization to proceed, the development of institutions supporting a market economy is vital. Without institutional arrangements that allow market competition, the spread of economic liberalism will not extend beyond the privatized firm and much of the effort put into restructuring stemming from privatization will be for naught.

The specific factors that make up an institutional context favorable to privatization include well-developed competition policies and regulatory frameworks, as well as a functioning system of property rights. In the case of the privatization of natural monopolies, particularly those providing water supply or transportation infrastructure, regulatory frameworks are especially important in order to ensure that firms do not exploit their market power, potential environmental hazards are kept in check, and collusion is avoided (Galal et al. 1994). The regulation of prices is a key mechanism that the government can use to protect consumers. Prices should be low enough to ensure access to a large number of consumers, but high enough for the firm to garner a fair return on its product. However, in some cases prices do in fact need to be raised in order to decrease government subsidies and recover costs, thereby increasing efficiency (Galal et al. 1994).

In terms of competition policies, divestiture of an SOE into an uncompetitive market may not necessarily produce any significant differences or new results. Instead, the rents accrued by the state from monopolies may merely shift to the private owners, thus depriving the government of a source of revenue without benefiting consumers. What is needed is a competition policy and regulatory framework that protects consumers from exorbitant price hikes and ensures free entry of firms into the marketplace. A study of privatization of SOEs in Chile, Malaysia, Mexico, and the United Kingdom found that the introduction of an effective regulatory framework prevented a deleterious social impact, even in the cases of pure monopolies (Galal et al. 1994). In some countries, such as Latvia, the Privatization Agency works with the government body that promotes competition to actively prevent privatization from producing private monopolies (Karklins, survey response, 1999). Additionally, regulations should be clearly spelled out not just for prices, but also for tariff formulation, market entry, technical standards, anti-trust laws, and conflict resolution/arbitration mechanisms to settle potential disputes (Galal et al. 1994). Failure to address these issues, particularly when privatizing larger enterprises, can result in large vertically integrated firms completely dominating the nascent free markets. Lastly, if regulatory institutions lack the capacity to enforce regulations or have unclear regulatory policies, the potential for regulatory failure looms large.

The development of a property rights system is another institutional determinant of the success of a privatization program (Boardman and Vining 1989). A system of property rights legally allows and protects the private use of an asset and the right to sell and profit from the use of such

an asset. Such a system helps protect the potential rewards from risk-taking and encourages investment. A solid legal basis for property rights is also instrumental in creating public support for privatization. Without this, it will be difficult to convince local entrepreneurs that by investing in the local firms they may benefit from privatization.

Macroeconomic Context

Just as institutional development is important to the successful outcome of the privatization process, the macroeconomic environment of a country can have profound effects on the ability of both the state and the private sector to gain from the transfer of firms' ownership from the state to the private sector. The macroeconomic context refers to the market structure of the economy, macroeconomic stability, the financial sector and capital markets system, and level of national economic development. In terms of market structure, as discussed already above, competitive markets are needed to ensure that profit-maximizing behavior is encouraged to promote cost-efficient methods of operating. Increased competition in such a market environment should lead to increased productivity and efficiency. Furthermore, it is recommended that an "accommodating" market environment be developed prior to or during the privatization process rather than after (Havrylyshyn and McGettigan 1999). The reason this is recommended is that a strong correlation exists between the processes of market development and privatization. That is, the method of privatization selected may depend upon the market institutions already in place. Conversely, certain ownership structures and privatization methods may result in better development of a market environment than other structures or methods.

Macroeconomic stability is conducive to private sector development. In an unstable macroeconomic environment, where inflation and high interest rates persist, private sector development can be adversely affected because the costs of private sector investment are high and private sector borrowing becomes constrained (Havrylyshyn and McGettigan 1999). For example, if interest rates do not reflect real capital costs and capital markets are weak or absent, the transfer to the private sector will not resolve the problem of inefficiency. Another important issue is the reduction of soft budget constraints. This means a conscious effort by the government to reduce subsidies, collect tax arrears, and enforce overall financial discipline. This enforcement of discipline can be greatly enhanced if a strong system of banking regulations and bankruptcy legislation exists. Without a strong banking system, the provision of "bad" loans is likely to continue, potentially leading to increased bankruptcies and unemployment (Havrylyshyn and McGettigan 1999).

The size of a country's capital markets/financial sector can affect the sales of the SOE and its potential for success. As Lanza (1995) points out, the role and structure of a country's financial sector is an essential element for meeting the government's privatization objectives of increased equity and efficiency. Why is this so? Lanza claims that the financial sector ultimately establishes the mechanisms that provide citizens the opportunities to participate fairly in the privatization transaction. That is, the financial sector provides the public access to capital resources, helps weigh the risks and opportunity costs of financial decisions, creates a basis for competition for assets and establishes appropriate prices for capital, and provides liquidity to individuals who may be potential bidders (Lanza 1995). Since equity and efficiency are two of the government's main privatization objectives, a well-developed financial sector can have considerable impact on the attainment of these objectives. Furthermore, if a country's capital

markets are small or underdeveloped and the SOE to be divested is large, the sale of the SOE to foreign buyers may be necessary. This may have the negative effect of allowing the benefits of the privatization transaction to accrue to actors outside the confines of the national economy.

The level of macroeconomic development of a given country probably plays less of a role than the preceding factors, but can be a considerable factor nonetheless (Galal et al. 1994). Divestiture is likely to be more successful in advanced industrialized countries because markets tend to be larger and the financial sectors more developed than in developing countries. Another issue here concerns the level of external debt. Because developing countries typically maintain high external debt burdens, the sale of SOEs to foreign investors may be an important strategy to reducing debt. Of course, this would mean that the bulk of the benefits accrued from the sale went outside of the country.

IV. KEY PRIVATIZATION AND POST-PRIVATIZATION ISSUES

Once the decision has been made to engage both in privatization and the necessary restructuring and economic liberalization that accompanies it, several issues arise that need to be examined. The sale of state enterprises to the private sector almost by definition means a shift in employment and investment structures. While this may provide numerous benefits in the medium and long term, there is bound to be a period of adjustment where workers may be temporarily displaced. Additionally, the state and the firm will need to reevaluate their roles in the marketplace as the burden of ownership shifts from the public to the private sphere. These changes may, in fact, be cause for concern, but with an understanding of the issues and a willingness to plan ahead, their impact can be reduced.

Employment

Does Unemployment Really Rise?

As countries embark upon a privatization program, one of the major concerns of these often economically struggling nations is what effect privatization will have on unemployment. In many of these countries state-owned enterprises are inefficient and over-staffed. The fear is that as more and more firms fall into the hands of private owners, this sort of inefficiency will no longer be tolerated in the liberalized marketplace and will result in large scale redundancies. In regions or countries, such as Jordan, where state-provided jobs serve as the main social safety net, the fear of a drastic increase in unemployed workers is particularly acute. While privatization schemes are usually part of a broader macro-economic restructuring which serves to trigger shifts in employment patterns, numerous studies suggest that worker layoffs are not as large nor as widespread as once feared.

The realization that newly privatized firms are not shedding as many workers, or as quickly as was expected, has come from a variety of sources. The International Labour Organization commissioned a study of the impact of privatization on employment in selected countries and found that statistically, the rate of job reduction in privatized and state-owned firms was similar (Evans-Clock and Samorodov 1998). In fact, much of the job loss that accrues during the privatization process occurs prior to the actual privatization as the government engages in preliminary restructuring either in hopes of getting a higher selling price for the firm, or as part of a broader economic liberalization program. On a macro-level, most countries have found employment as a whole rose after privatization, as firms faced rising demand due to lower production costs and began to hire more workers.[5] An important caveat to the generally positive picture of employment and privatization is the experience of privatizing large-scale industries. Large, state-owned utilities and production plants have tended to be excessively overstaffed and labor-intensive, leading to large cuts in employment of low-skilled, nontechnical workers as private companies seek to modernize.

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[5] The most comprehensive study of firms in developing countries' actions post-privatization found that two-thirds of the firms exhibited an increase in employment, with an average of a 6 percent increase (Megginson 1995).

Who Gains? Who Loses?

While on the whole, privatization seems to result in higher employment in the medium term, there are redundancy issues that are of concern to policymakers. Rather than look at employment in general terms, successful handling of employment issues post-privatization requires a more nuanced approach.

The first step is to identify which workers are most likely to gain or lose from changes arising from the change in ownership and then tailor employment and benefit schemes to help those most negatively impacted. Several studies have suggested that the workers hardest hit during privatization layoffs are those filling clerical and administrative positions, as well as other white collar workers, while at the same time there is often a shortage of workers with technical skills available to employers.[6] As white collar workers typically form the core constituency of the government, the government is often under pressure to take measures limiting the competitiveness of the industries in order to protect this group, while failing to provide adequate schemes for the unskilled and poor with limited access to education or training. The increased need for trained, skilled workers as firms become more profitable suggests that rather than preventing redundancies, government schemes should target skills training.

This conclusion is further bolstered by the fact that skilled workers who remain at privatized firms often find themselves far better off after the privatization as salary levels at the firm rise to keep and attract skilled workers. Furthermore, experience has shown that after large-scale redundancies, a significant number of workers choose to retire after receiving an often generous severance package and do not reenter the workforce.[7] The higher salaries and increased demand for workers over the medium term suggests that the best way to raise living standards for workers is to promote efficient privatized firms (to increase the demand for skilled workers) while providing a social safety net for redundant workers and offering increased job and skills training (to increase the supply of skilled workers).

Privatization and the subsequent shifts in employment patterns within the economy have tended to result in increased wages and decreased unemployment. However, the portability of benefits that were once the staple of government guaranteed jobs, become a concern with privatization. Often, employees were given housing, education, or health care as part of the pay package at state-provided jobs. This is particularly important to workers in countries such as Jordan where government employment provides benefits that would normally accrue if a formal social safety net existed within the country. As the majority of the jobs shift to the private sector, these fringe benefits are often lost, leaving workers without a social safety net. In order for privatization to benefit the majority of the population, it is extremely important that the government, ahead of the actual privatization, address how previously provided services are going to be accessed in the post-privatization environment. Simply increasing employment or even wages will not increase

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[6] See, for example, Bhaskar 1992 or Kikeri 1998.

[7] For example, a study of the privatization of Turkey's cement industry found that 70 percent of the redundant workers retired upon dismissal and did not return to the workforce (Aysit Tansel, "Workers Displaced Due to Privatization in Turkey: Before Versus After Displacement," 1996, quoted in Kikeri, 7).

the standard of living in a country if such basic services as health care and education are denied of the majority of the citizens.

Common Practices Dealing with Unemployment

There are a variety of ways for policymakers to address the needs of the unemployed following privatization. These range from enacting legislation at the beginning of the privatization process that offers "golden handshakes" to providing job training and help with finding a new job.[8] Various countries have used different combinations of the above choices to varying degrees of success. All of the experience points to the need to plan ahead and take heed of the needs of those that are being targeted.

Legislation/Contracts Limiting Layoffs. Numerous countries, worried about the possible negative effects privatization might have on employment, have sought to limit layoffs by either formal methods such as making layoffs illegal for a certain period of time following the sale of a state-owned enterprise, or informal methods such as considering staffing plans by various bidders. The introduction of procedures or clauses in sales contracts that stipulate staffing levels is a common way of attempting to reduce mass redundancies in firms. This option has been used in a variety of countries, including Benin and Zambia that have a five-year "no layoff" clause in standard privatization contracts (White 1997). Uzbekistan has used a tripartite contract system between the State Property Committee, the Ministry running the company, and the bidders to ensure that the company does not change its profile or reduce the number of employees for a period of five years (Jakhongir Atakhanov, survey response, 1999). By doing this, countries manage to prevent a one-time large-scale drop in employment, of particular concern for countries privatizing large numbers of firms at the same time or privatizing very large enterprises. Of concern, however, with this approach is the lack of flexibility it entails and the possibility of doing nothing more than putting off needed restructuring for a few years.

Other countries have taken a less institutionalized approach to the problem. Mozambique does not require staffing levels to be maintained by new private owners, but does consider commitments to maintain labor force levels when evaluating bids for state-owned enterprises. The winners of the bid to privatize Mexico's Telmex were chosen in part because the new owners agreed not to adjust labor force levels over the medium term (Kikeri 1998). This approach has the advantage of allowing a case-by-case examination of the levels of overstaffing at state-owned firms and preventing private bidders from being forced to maintain employment levels that may be unsustainable and cause the eventual bankruptcy of the firm.

Severance/Retirement Packages. Most countries engaged in privatization have instituted policies regarding severance and retirement packages for employees affected by a firm's sale. How these levels have been set varies from country to country. Some countries, such as Pakistan, require a one-time pay off but allow specific minimums to be negotiated by individual workers unions (Waqar Haider, survey response, 1999). Other countries, such as Madagascar, have instituted labor laws with minimum separation levels (Thierry Rakotoarison, survey response, 1999).

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[8] These "handshakes" refer to severance payments given to workers to encourage voluntary termination of employment.

These one-time payoffs vary in size, from a few months' to a year and half's salary; they serve to not only provide a bit of breathing room while the worker looks for another job, but can provide capital for workers wishing to start their own microenterprises. The key to managing these payoffs successfully is setting an amount that while healthy, is not too high, lest needed skilled workers may choose to leave the firm and seek employment elsewhere or governments may not have sufficient funds to cover promised payments and lose political support.

Once levels of payment have been agreed upon, either via negotiation or legal requirements, the government must make sure that these obligations are met. If the responsibility for payment rests with the new owners, the government is required to play a role in monitoring and ensuring proper compliance. If layoffs take place prior to sale and are therefore the responsibility of the government, it is imperative that the government make sure the necessary funds are in place.[9] Should the government fail in either case, it risks losing credibility, thus making it harder politically to proceed with privatization, and economically it risks higher payoff and welfare costs in the long run.

Retraining or Job Placement Assistance. Perhaps the most important type of assistance a government can provide in the long run for displaced workers—help finding a new job or gaining the skills necessary to be competitive in a country's newly liberalized marketplace—is often the hardest to find. Retraining schemes are relatively rare in most countries engaged in privatization. Those that do exist are often too generic to be of much use to laid-off workers or are not sufficiently advertised to attract much business. Job placement or retraining schemes that are market-oriented, and are up and running early with a staff fully aware of upcoming market trends and what skills are needed by the newly privatized firms, can help workers make the transition from state-owned enterprises to the private sector more quickly. In addition, policymakers need to take particular notice of the age distribution of those workers being laid off. Older workers, closer to retirement, are going to be more concerned with severance payments and less likely to re-enter the work force or choose to take advantage of retraining schemes than younger workers. Failure to note this difference may result in precious funds being squandered. While retraining and job placement programs may offer the best support if run correctly, they are often quite expensive and can be a large financial drain with little benefit if they are run in the same inefficient manner as many traditional state enterprises.

Addressing the Concerns of Labor Movements

In order for the privatization process to be successful, it requires widespread citizen support. In addition to providing material support for workers whose jobs are threatened or eliminated by the sale of state-owned enterprises, governments' best hope of garnering vital worker support is to ensure that labor movements, who might otherwise be the greatest source of opposition to privatization, are stakeholders in the process. Failure to do so may result in a general sense of disillusionment with the privatization process or more concrete action as recently occurred in the Bahamas when telecommunications workers struck after feeling that the government had lied

[9] This can be done in a variety of ways such as sequestering private proceeds; sequencing privatization candidates to minimize cash flow problems; setting aside budgetary funds to cover obligations; and sharing the burden with the new buyer, keeping in mind that the final option will often serve to lower the selling price (Kikeri 1998).

about their severance packages (Reuters 1999). By including labor in decisions about selling firms, and making sure that all workers have access to reliable information throughout the entire process, workers are better able to see the possible benefits they may accrue. Additionally, the inclusion of workers in the process ensures that they obtain a stake in the process, making them more likely to both support the process and try to convince others of its worth.

Evolving Role of the State and the Private Sector

The Role of the State

When a government embarks on privatizing state enterprises, it does so for a variety of reasons: to gain hard currency, to resuscitate a stagnant economy, or to bring its economy more in line with today's leading neo-liberal economic model. For as many reasons as there are for privatizing, there are various degrees of privatization ranging from complete divestiture to the sale of only a portion of a firm's shares. Experience has shown however, that no matter what the degree of divestiture, the role the state plays in a former SOE changes drastically after privatization.

While, ideally, the aim of privatization is to eliminate government ownership of economic entities, this is often impossible due to concerns regarding strategic interests, lack of interest by foreign investors, hopes of gaining a higher price once the market has developed, or lack of an adequate capital market to effectively facilitate transfer of ownership. As a result, the government often maintains a "golden share" in privatized firms. When the government maintains an interest in a firm, no matter how small, its behavior is extremely critical. It is increasingly important for the government, as it becomes more active in regulatory affairs of these enterprises, to be conscious of possible conflicts of interest arising from its dual owner and regulator roles (Lieberman 1997).

In economies where the state owns or runs a large number of enterprises, investors are used to interacting with the market in a particular fashion that is rarely based on purely economic efficiency concerns. Rather, decisions are often based on the knowledge that the state will not allow its firms to fail and put people out of work, no matter how dismal their record, and that political concerns are often more important than economic ones when it comes to making business decisions. It is imperative, if a government wants to foster a market economy, that it not impose such concerns on newly privatized enterprises where it maintains some amount of ownership. Should governments provide subsidized credit or soft budget constraints, override managerial decisions, or impose economically inefficient business practices to save employment or placate a political clientele, they run the risk of undermining investors confidence in purely private firms and hindering the development of the economy in the long run (Frydman et al. 1997). The Ukrainian experience with electricity privatization highlights what can happen when the government fails to remove political concerns from business decisions. The unwillingness of the Ukrainian government to give up control of the regulatory commission or to allow them to crack down on politically sensitive clients who refused to pay their electricity bills continues to jeopardize the financial viability of the entire electricity sector in Ukraine (Lovei 1998).

Even when a government maintains no direct interest in a formerly state-owned enterprise, its role in the economy evolves beyond a simple hands-off approach to the marketplace. In many

cases, the government's ownership role in the economy has resulted in a lack of market-oriented institutional development. The first task in the government's new role is often that of information dissemination—keeping the population both at home and abroad apprised of the new developments and what this may mean for them. As the government continues to work on the early phases of privatization, it must begin the important longer-term tasks of addressing such concerns as labor mobility and private property laws, the development of the capital market, and the regulation of privatized natural and economic monopolies. While the first two issues have, to a large extent, been dealt with in the previous section of this paper, the issue of monopoly regulation deserves a bit more discussion.

Often, when a government privatizes, the commonly sold off enterprises include such things as utilities, large-scale production plants, or airlines. These types of enterprises often exist as natural monopolies (such as utilities or airlines) or as state-sanctioned monopolies based on size and theoretical efficiency gains. As these monopolies shift from public to private hands, for both economic and political reasons, the rents from these endeavors should not simply fall to the owners of the enterprise. The state may take various avenues to prevent this from occurring, including encouraging the development of competitors for nonnatural monopolies, to regulating utility tariffs. While it is often expensive to regulate the formerly state-owned enterprises due to the sheer volume of legislation needed, the state is often the only one with the ability to protect the consumers' interests in a developing market (Frydman et al. 1997). By taking on this role, the state can maintain the necessary political support needed for the privatization process and its accompanying economic restructuring.

One final issue pertaining to the government's role in privatization is that of taxation and revenue. As the government sells off state-owned enterprises, the make-up of government income undergoes realignment. While there is often a one-time windfall from the sale of government assets, the on-going revenue from formerly owned firms (at least from those that were able to make a profit) is lost. As a result the state must be more concerned about the tax code and collecting tax revenue, particularly revenue from the newly privatized firms. The government should take advantage of this windfall and use the revenue to address the issues confronting workers displaced by the economic restructuring and develop a social safety net to protect the poor.

The Role of the Private Sector

Just as the role of the state evolves during the privatization process from owner to supporter and regulator, the role of the private sector emerges as a more dynamic and complicated one than previously. No longer is the private sector the passive junior partner in the economy, instead it is faced with making the tough decisions both on the micro- and macro-levels and will succeed or fail based on those decisions.

One of the first issues that must be addressed by the newly privatized firm are those regarding management. To a large extent, under state ownership, managers were often chosen based on political concerns rather than managerial ability. After privatization, the new owners are in a position to install new leadership and often do so by importing managers from their home offices. While this serves to address concerns regarding managerial experience on a short-term basis, over the long term firms will be forced to rely on domestic talent for lower and middle-

management positions. In order to fulfill these needs, firms will need to identify workers with managerial talent and provide both incentives and training for workers to ensure long-term stability and profitability within the firm.

On a structural level, newly privatized firms often inherit product structures that include not only areas where the firm has a market and the ability to compete, but also a variety of noncore products that were produced for either political or strategic reasons under state ownership. In order to remain economically competitive, firms will be forced to reassess their products, often resulting in selling off or shutting down noncore activities. Newly privatized firms in developing and transitional countries often face such pitfalls and challenges as the over-estimation of the market for their products, lack of skilled labor, and the need to update their technology. Firms will need to address long-term strategic planning along with short-term cash-flow concerns to overcome these obstacles, without relying on state industrial or development plans.

Perhaps one of the most technically challenging aspects of privatization for the firm involves reporting and monitoring requirements. After privatization, it is no longer sufficient to report on the number of outputs a firm manages to produce in a given year in hopes of attracting investment or satisfying reporting requirements. Instead, firms are faced with the need to conform to international accounting standards and reassess their profitability.

While few countries require that newly privatized firms submit special reports to either the central government or the governmental privatization body, most enact various general accounting and reporting requirements that apply to all firms in order to align with world standards. Often this means filing reports with their respective securities and exchange commissions or to the government to attest that the firm is in line with regulations regarding monopoly legislation. While this does not put a special burden on newly privatized firms in terms of extra reporting requirements, it does require that firms invest the time in training managers and accountants in the new reporting structure.

In addition to changes in the way firms report their results, privatization often forces companies to reassess the way they measure their successes and failures. Numerous studies have been commissioned in order to compare the success of firms pre- and post-privatization using a variety of benchmarks. In general, firms have been assessed not only in terms of profitability but also in terms of increased efficiency. There are a variety of ways of measuring efficiency in resource allocation, productivity and profitability, the most common being rate of return on total net assets (ROA); rate of return on sales revenue (ROSR) and the rate of return on equity (ROE) (Van der Hoeven 1997); the level of total employment; the debt to asset level or leverage; and the dividend to sales level (Megginson 1994). Most companies will find that a combination of various performance measures will be required to conform with reporting laws and as a result will need to begin to compile data and train staff to keep the appropriate records.

While the state and private sector face a variety of challenges regarding the effects of privatization, both need to reorient themselves towards a more market-based approach. As the government begins to implement long-range structural and institutional changes, privatized firms will be forced to react and adapt without the help of government directives and bailout money. In order for both sectors to be successful, they must continue to communicate both with each other and with the population at large to ensure the political support necessary for long-term success.

V. CONCLUSION

Lessons Learned

- *Privatization can provide numerous benefits for both the government and the newly privatized firm.* These benefits include higher profitability and enhanced efficiency and productivity for the firm; improved financial health of the public sector; development of the country's financial sector; and the freeing up of government resources to address other policy issues.

- *A period of corporate restructuring is almost always necessary for firms targeted for privatization.* The timing of restructuring can be determined by a cost-benefit analysis comparing the costs of laying off workers, installing new equipment, etc. with the increase in asking price likely to accrue to the state.

- *Although the type of owners of the newly privatized firm can vary, outsider-owners typically exhibit better revenue growth and tend to reduce labor at lower rates than SOEs or insider-owned firms.* In insider-owned firms, the managers or employees are the owners but these firms tend to exhibit higher operating costs and lower productivity growth rates than many state-owned or private companies.

- *Public offerings or mixed sales are generally recommended over mass voucher privatization, direct sales, or concessions.* Public offerings and mixed sales offer the greatest opportunity to create a broad ownership base, assist in the development of capital markets, and are attractive to foreign investment. Mass privatization through vouchers is generally not recommended unless political acceptability is a serious constraint to privatization.

- *An appropriate enabling environment, consisting of certain institutional and macroeconomic factors, is necessary to reap the full benefits of privatization.* Legal and regulatory frameworks that encourage competition and free entry into the marketplace are essential institutional ingredients to allow privatization to succeed. Macroeconomic factors such as a competitive market structure, a well-developed financial sector and capital markets, and a system of property rights are also key to the privatization process.

- *Although some layoffs do occur after divestiture of an SOE, many studies suggest that privatization does not necessarily lead to significant or widespread unemployment as is generally believed.* Studies cited in this paper have shown that job reduction in privatized and state-owned firms has been quite similar. In those cases where layoffs have occurred, they usually take place prior to the actual privatization as part of the early stages of restructuring.

- *In order to address the potential for unemployment increases in the short term, governments must have a targeted plan in place before engaging in the sale of state-owned enterprises.* The transition between state employment and private employment can be made easier by providing severance packages, "golden handshakes," and job placement or retraining assistance.

- *To ensure the support of labor, workers should be fully informed of the steps the government is taking with regard to privatizing firms.* Workers are often concerned about the perceived increase in unemployment brought on by privatization. By keeping workers apprised of government activities and the potential benefits, the state can co-opt the labor movement and turn them from a possible obstacle to a stakeholder in the process.

- *The privatization process generally leads to a changing role for both the state and the private sector.* In the case of the state, its role changes from owner to supporter or regulator of the newly privatized firm and the market it operates in. In the case of the private sector, it begins to take on a larger role than before the privatization process. This role entails encouraging profit-maximizing behavior and incentive-based performance of managers and workers, improving productivity and efficiency, and reducing operating costs.

Countries engaging in the privatization process are given the unique opportunity to not only restructure their marketplaces but to reevaluate the services they provide. As governments become less involved in the day-to-day running of individual firms, they have the chance to step back and take a comprehensive look at the role they play in the lives of their citizens. The windfall accrued from the sale of state-owned enterprises can allow governments to reinvest in its citizens and economy, and provide an important step toward long-term sustainable development.

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