

ST/ESA/PAD/SER.E/19

**Department of Economic and Social Affairs
Division for Public Economics and Public Administration**

**PRIVATIZATION AND
REGULATION IN DEVELOPING
COUNTRIES AND ECONOMIES IN
TRANSITION**



United Nations • New York, 1999

NOTES

The designations employed and the presentation of material in this publication do not imply the expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country, territory, city or area or of its authorities, or concerning the delimitation of its frontiers or boundaries.

The designations "developed" and "developing" economies are intended for statistical convenience and do not necessarily express a judgement about the stage reached by a particular country or area in the development process.

The term "country" as used in the text of this publication also refers, as appropriate, to territories or areas.

The term "dollar" normally refers to the United States dollar (\$)

The views expressed are those of the individual authors and do not imply any expression of opinion on the part of the United Nations.

Comments and inquiries regarding this report may be directed to:

Mr. Guido Bertucci
Director, Division for Public Economics and Public Administration
United Nations, New York, N.Y. 10017
United States of America
Fax : 1-212-963-9681

Telex: 42231 UN U1

EXECUTIVE SUMMARY

The withdrawal of Governments from the role of producing and delivering services, and their assumption of the dual roles of enabling and regulating, are major changes in the way that societies provide for their needs. Governments enable private delivery of services through financing, subsidizing, promoting and contracting. They regulate by setting policy, legal frameworks and standards of operation. These new tasks are more difficult and complex than governments had before. New organizational structures have to be built and new skills imparted to carry out new functions, and new attitudes developed to displace a culture of risk avoidance and secrecy. Governments need to be able to analyse market conditions; set policy frameworks; draw up, negotiate and enforce contracts; regulate monopolies; coordinate, finance and support producers; enable community self-provision; and provide consumers with information on their options and remedies. There is a growing realization that privatization is not the end of government participation but rather a new beginning.

The new paradigm of governance stresses decentralization, subsidiarity, use of public-private partnerships and Non Governmental Organizations (NGOs) in former public functions, self-regulation by industry and professional associations, and citizen participation in policy formulation and implementation. Regulation is also being contracted out, eg. to specialist NGOs and firms, where they can do a better job of surveillance than a government agency.

The present document presents the report of the experts together with in depth studies of various aspects of privatization and regulation such as: corporate governance and restructuring, stock market growth in developing countries, mobilization and support, social impact and promotion of competition and policies concerning monopolies. In addition a number of country experiences (Ghana, Jamaica, Malaysia, Poland) are analysed.

iii

FOREWORD

In view of these rapid changes, and in fulfilment of United Nations General Assembly resolution 52/209 of 18 December 1997, the United Nations Department of Economic and Social Affairs held a Meeting of Experts on Privatization and Regulation in Developing Countries and Economies in Transition, in New York 16-18 February 1999. The meeting was supported by the World Bank, IMF, ILO and EBRD, and included practitioners from a number of countries,

academics, consultants, and UN-DESA staff members. This publication presents their papers and the overall report of the Meeting.

We acknowledge with thanks the contributions of Mr Constantine Vaitos, Mr Mark Dutz and Ms Maria Vagliasindi, Mr David Hale, Mr Ahmed Galal, Mr D.M. Bhouraskar, Mr Sanjeev Gupta, Mr Henry Ma and Mr Christian Schiller, Mr Shyam Kemani, Ms Tessie San Martin, Mr A. Horn and Ms S.R. Kim, Mr Tonny Bennett, Mr Keith Hillyer, Mr G.B. Opoku, Mr Leroy Phoenix, Ms Hanifah Hassan, and Mr Ryszard Rapacki.

Guido Bertucci
Director
Division for Public Economics and Public Administration
Department of Economic and Social Affairs.

ABBREVIATIONS

ASEAN	Association of South East Asian Nations
BO	build-operate
BOO	build-own-operate
BOT	build-operate-transfer
BT	build transfer
CAFRAD	Centre Africain de Formation et de Recherche Administratives pour le Developpement
CCC	Caribbean Cement Company (Jamaica)
CEE	countries of Eastern and Central Europe
CIS	Commonwealth of Independent States
CPI	consumer price index
DCF	discounted cash flow
DIC	Divestiture Implementation Committee (Ghana)
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECOWAS	Economic Community of West African States
EDI	Economic Development Institute
ENTEL	Argentine telecommunication company
EPU	Economic Planning Unit (Malaysia)
ERP	Economic Recovery Programme (Ghana)
ESAF	Enhanced Structural Adjustment Facility (IMF)
ESOP	employee share (or stock) ownership plan
ESOS	Employee Share Ownership Scheme (Malaysia)
FAO	Food and Agriculture Organization
FDI	foreign direct investment
FINSAC	Financial Sector Adjustment Company (Jamaica)
FSU	former Soviet Union
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product

IBRD	International Bank for Reconstruction and Development (World Bank)
ICAO	International Civil Aviation Organization
IDB	Inter-American Development Bank
ILO	International Labour Organization
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
IPANet	Investment Promotion Agencies Network
IPO	initial public offering
ITU	International Telecommunications Union
JPSCo	Jamaica Public Service Co. (light and power company)
MEBO	Management/employee buyout
MPP	mass privatisation programme
NGO	non-governmental organization

ix

NIBJ	National Investment Bank of
NIF	National Investment Funds programme (Poland)
NPV	net present value
NIS	new independent states of the former Soviet Union
OECD	Organization for Economic Co-operation and Development
PROTON	Perusahaan Otomobil Nasional (Malaysia)
R & D	research and development
RPI	retail price index
SAF	structural adjustment facility (IMF)
SAI	supreme audit institutions
SEC	State Enterprises Commission (Ghana)
SMI	small or medium-scale industry
SOE	State-owned enterprise
SOERP	State-Owned Enterprise Recovery Programme (Ghana)
TNC	trans-national corporation
TRIMs	trade-related investment measures (WTO agreement)
TRIPs	trade-related intellectual property (WTO agreement)
UN	United Nations
UNCITRAL	United Nations Commission on International Trade Law
UNCTAD	United Nations Conference on Trade and Development
UN-DESA	United Nations Department of Economic and Social Affairs

Introduction: Report of the Experts

UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
UNIDO	United Nations Industrial Development Organization
USAID	United Nations Agency for International Development
VIF	voucher investment funds
WHO	World Health Organization
WTO	World Tourism Organization
Y2K	Year 2000 (computer p

CONTENTS

	Page
Foreword.....	i
Notes.....	ii
Abbreviations.....	iii
I. Report of the Experts	1
A. Nature and present state of privatization	1
B. The global context.....	1
C. Corporate governance and restructuring.....	2
D. Capital markets	3
E. Political economy of privatization.....	3
F. Mobilization of support.....	4
G. Social impacts and safety nets	4
H. Regulation and the promotion of competition	5
I. Valuation of enterprises	6
J. Accountability, transparency and corruption.....	7
K. International cooperation	7
II. Globalization, Financial Instability and Privatization	10
<i>By: C. Vaitzos, Professor, Department of Economics, Athens University</i>	
A. Globalization: definition and comparative experience	10
B. Privatization issues.....	13
III. Corporate Governance and Restructuring: Policy Lessons from Transition Economies	15
<i>By: Mark Dutz and Maria Vagliasindi, Office of the Chief Economist, European Bank for Reconstruction and Development, London</i>	
A. Introduction	15
B. Corporate governance and its links to restructuring.....	16
C. The experience of transition economies.....	19
Table 1 – Privatization methods for medium large enterprise.....	21
Table 2 – Business environment indicators.....	27
Table 3 – Restructuring related indicators	28
D. Policy lessons: recommendations for ongoing and future Privatization.....	29
References	31
IV. Stock Market Growth and Privatization in Developing Countries	33

*By: David Hale, Economic Advisor, Zurich Insurance Group, Chicago
and a Private Consultant*

A.	Expansion of stock markets and its sources.....	33
B.	The financial crisis of 1997-1998 and the future of the emerging Markets	34
C.	World market capitalization.....	40
V.	The Political Economy.....	46
	<i>By: Ahmed Galal, Adviser to the World Bank</i>	
A.	Introduction.....	46
B.	Political optimality.....	46
C.	Ex-post analysis	47
	Figure 1.- Overall gains and foreign gains.....	49
	Figure 2 - Impact on buyers	50
	Figure 3 – Impact on governments	51
	Figure 4 – Impact on workers	52
	Figure 5 – Impact on consumers	53
D.	Ex ante stakeholder analysis	55
	Table 1 – International Comparison of Telecom Performance (1994).....	55
	Figure 6 –Distribution of the net present value and potential welfare gains from reform of Egypt Telecom	56
VI.	Mobilization of Support for Privatization.....	58
	<i>By: D.M. Bhouraskar, Baruch College, City University of New York</i>	
A.	Introduction.....	58
B.	Domestic support	59
C.	External support.....	62
D.	Conclusions.....	63
VII.	Privatization, Social Impact and Social Safety Nets.....	64
	<i>By: Sanjeev Gupta, Henry Ma and Christian Schiller, Expenditure Policy Division, Fiscal Affairs Department, International Monetary Fund</i>	
A.	Introduction.....	64
B.	Social impact of privatization	65
C.	Fiscal implications	68
D.	Methods of privatization: social and fiscal impact	69
E.	Policy responses.....	71
F.	Experiences under IMF-supported programmes.....	73
G.	Concluding remarks	75

References.....	76
VIII. Promotion of Competition	78
<i>By: R. Shyam Khemani, Private Sector Development Department, World Bank</i>	
A. Dimensions of competition	78
B. Insufficiency of deregulation and liberalization	78
C. Instruments of competition policy	80
D. Conclusion	80
IX. Valuation and Finance Issues in Privatization: The Perspective of a Government Advisor.....	82
<i>By: Tessie San Martin, Washington Consulting Practic, Price WaterhouseCoopers LLP, Arlington, Virginia</i>	
A. Introduction.....	82
B. Valuation.....	83
Table 1 – Privatization methods for medium and large enterprises in seven transition economies.....	85
C. Financing privatization: The challenges ahead.....	87
D. Infrastructure – the next frontier in privatization.....	87
E. Post-Privatization support.....	89
F. Conclusion	89
Appendix A. Valuation Techniques.....	90
X. Regulation Policies Concerning Natural Monopolies.....	93
<i>By S.R. Kim and A. Horn, Division for Public Economics and Public Administration, Department of Economic and Social Affairs, United Nations</i>	
A. Introduction.....	93
B. Defining natural monopoly and its current regulation policy agenda.....	93
C. Actual responses and experiences in developing and transition economies	98
Table 1 – Network industries: Modes of privatization and sector reform.....	100
D. Conclusions and recommendations.....	110
References.....	111
XI. Accountability, Transparency and Corruption in Privatization and Monopoly Regulation.....	113
<i>By: Tony Bennett, Interregional Adviser, Department of Economic and Social Affairs, United Nations</i>	
A. Introduction.....	113

B.	Types of corruption and impacts on privatization goals	115
C.	Corruption in privatization.....	116
D.	Corruption in the regulation of monopolies.....	119
E.	General strategies of deterring and detecting corruption.....	120
F.	Conclusion	123
	Annex	124
	References.....	125
XII.	International Cooperation in Privatization Programme and Policy Management	127
	<i>By: Keith Hillyer, REDMA Consultants Ltd, Mississauga, Canada</i>	
A.	Introduction.....	127
B.	International investment and trade.....	127
C.	What role exists for the international aid community.....	128
D.	Some lessons to be learned	129
E.	Technical cooperation in capacity building and sustainable institutional development.....	130
F.	Inter-agency Cooperation.....	131
XIII.	The Ghana Experience	132
	<i>By: G.B. Opoku, State Enterprise Commission, Ghana</i>	
A.	Introduction.....	132
B.	The need for divestiture in Ghana.....	132
C.	The divestiture programme	133
D.	The implementing agency	133
E.	Enterprises to be divested	134
F.	Mode of divestiture	134
G.	Results of divestiture so far.....	134
H.	Divestiture and investment opportunities	135
I.	Incentives for investors	135
J.	Divestiture receipts and payments	135
K.	Assessment of the impact of divestiture on the national economy	136
L.	The way forward	137
M.	Recommendations.....	137
N.	Conclusion	137
XIV.	New Developments and Issues Arising in Jamaica's Privatization Programme and Critical Factors in its Success.....	139
	<i>By: Leroy Phoenix, National Investment Bank of Jamaica</i>	
A.	The privatization programme.....	139
B.	New developments in privatization	141
C.	Issues.....	143
D.	Critical factors for success	144

E.	Conclusion	145
	References	145
XV.	Privatization in Malaysia	146
	<i>By: Hanifah Hassan, Privatization, Economic Planning Unit, Prime Minister's Office, Malaysia</i>	
A.	Introduction.....	146
B.	Conditions for privatization	147
C.	Selection of privatization mode in Malaysia	147
D.	Privatization policy issues.....	148
E.	Pre-requisites for success	151
F.	Policy issues.....	153
G.	Uniqueness of Malaysian privatization.....	153
H.	Conclusion	153
XVI.	Privatization in Poland: Major Issues, Trends and Policy Concerns	154
	<i>By: Ryszard Rapacki, Warsaw School of Economics, Warsaw</i>	
A.	Introductory remarks.....	154
B.	Privatization in Poland in retrospect	154
	Table 1 – Ownership Transformation of State-Owned Enterprises in Poland, 1990-98	157
	Table 2 – Budget Revenues from SOE privatization, 1991-98 ..	157
C.	Recent privatization trends and major policy concerns	160
D.	Short-term prospects	161
	References	162
	Participants.....	164

I. REPORT OF THE EXPERTS

A. Nature and present state of privatization

Participants discussed the definition and nature of privatization and distinguished a narrow definition and a broad definition. Narrowly, privatization is defined as the transfer from the public to the private sector of the equity interest in public properties, and is conventionally measured in terms of the reduction in the share of State-owned enterprises in gross domestic product.

The broader view defines privatization as the process of rebalancing the role of the State. This includes start-ups and expansion of new private businesses (grass-roots or bottom-up privatization), and expansion of private investment in infrastructure and social services, as well as sale of SOEs. This is measured, overall, in terms of the share of GDP which is privately produced. Empirically, in transitional economies such as Poland, grass roots privatization has been responsible for much more of the increase of the private share of GDP than sales of SOEs. The definition has three parts: an exit from the delivery of commercial goods and services; an intensification of State commitment to enable expansion of private sector activities (strengthening the rule of law, provision of infrastructure, etc.); and policies and regulatory functions needed to promote the private sector, including the promotion of dynamic efficiency, stability of markets and environmental sustainability.

Privatization in this wider sense can be seen as a continuing process, rather than a series of individual transactions. It is an intensely political process, involving conflict among key stakeholders. At the same time, it is a demanding business process, needing high quality technical inputs. This calls for more governance and better quality governance. Privatization should not be seen as an exit from governance. Success depends on domestic institutional reforms, viz. reform of education (especially primary education), reform in capital market institutions, strengthening the rule of law and property rights, reduction of transaction costs, and pro-active industrial, technological and trade policies.

Participants heard about the state of world-wide privatization in its narrower sense. With about \$735 billion of privatization proceeds to date, the process is approaching the half-way stage. Though individual countries started at different dates (eg. Jamaica in 1981, Malaysia in 1983, Ghana in 1989), and have progressed at different rates, for many countries the easier privatizations have been completed—mainly the smaller and purely commercial enterprises. Some fast-changing utilities in which the natural monopoly argument no longer applies, such as telecommunications, have also been semi- or fully privatized. The remaining phase involves the “strategic” enterprises and problem sectors, in particular the big public utilities which have major social obligations. These are likely to be privatized more cautiously and only after adequate social controls are in place. The argument that competition, rather than private ownership, is the key determinant of economic efficiency gains, is likely to gain widespread acceptance, and to influence national privatization and regulation policies.

B. The global context

In the context of globalization, regionalization and recent financial crises, transborder flows of productive factors and of goods and services are becoming so strong that national decisions and national performance depend increasingly on decisions taken extranationally. However, the impact should not be exaggerated. Even though globalization, as measured by the ratio of exports to GDP, has increased to 15 per cent world-wide, this still means that 85 per cent of production, including the big public utilities and other non-tradeables, is for local markets.

The current globalization wave was compared with capital investment in the 1870-1913 era and two important differences were pointed out. In the past, productive capital inflows played a critical financial role in the receiving countries, amounting even to 40-50% of gross fixed capital formation. Now the ratio is much smaller. In South East Asia, capital flows for privatization have amounted to only 3-4% of foreign direct investment, to 15% in Latin America, less than 10% in sub-Saharan Africa. Only in central and eastern Europe did privatization flows amount to as much as 40% of FDI.

Secondly, nineteenth century international capital investment was financed largely by long-term bonds. Today, capital flows are mainly related to arbitrage, not trade or direct investment. Short-term flows from private and institutional investors dominate, causing an inherent instability. This affects privatization, as the timing of sale transactions is influenced by movements in exchange rates. Many countries have been forced to privatize while under stress in their external sector. Volatility in capital markets affects the terms of investment. According to research on Chile, 45 per cent of privatization capital was highly subsidized, due to economic conditions. In Brazil, the opportunity for substantial inflows was used as a pretext to support overvalued exchange rates. Fears were expressed that US stock markets, which account for about half of capitalizations world-wide, would have an adverse effect on emerging markets and on privatization through those markets, if the present boom collapses.

C. Corporate governance and restructuring

Privatization has not always led to the kind of radical restructuring needed either to develop firms' comparative advantage and enable them to compete in global markets or alternatively to exit as efficiently as possible. The lack of appropriate restructuring has been particularly acute in the case of transition economies. This is partly due to insiders (existing management and/or employees) gaining control of enterprises and opposing restructuring to the extent that it implies loss of their rents. More generally, it is due to the governance environment not being appropriate for decision-makers within firms to undertake socially-desirable decisions. Participants discussed the design of privatization and of systems of corporate governance which promote restructuring. In this context, "growth-oriented" restructuring, defined as restructuring which increases revenues, was distinguished from "survival-driven" restructuring, which is concerned only with defensive cost-cutting for breaking even.

While in general restructuring should be left to new owners, there are two sets of interventions that may be desirable before privatization takes place. First, in the case of dominant enterprises with substantial market power, there is an important role for horizontal and/or vertical separation according to competition policy criteria. This competition-enhancing restructuring should take place prior to privatization. Second, legal/financial restructuring—to clean up balance sheets, reduce excessive gearing, value contingent liabilities, resolve outstanding legal issues, convert the legal status of the enterprise to make it saleable and put its workforce under the same labour laws as the private sector—should also take place prior to privatization. On the other hand, governments are sometimes tempted to rehabilitate capital assets, restructure an excessive labour force, or undertake human resource development and other R and D expenditures in order to make enterprises more attractive to investors. This operational restructuring is better done by the

new owners in accordance with their business plan. Though the government may get a better price if such operational restructuring is successful, the expenditures are not likely to be fully recovered.

The problem of corporate governance is the principal-agent problem of how to control management when it is separated from ownership, typically relevant for larger enterprises that need substantial external financing. If share ownership is concentrated in one or a few hands, one of the crucial problems is to protect minority shareholders, particularly when the existing management controls the enterprise. If share ownership is widely dispersed, attention also should be devoted to protecting the larger investors (and creditors). In both cases, minority shareholder protection is important not just to ensure fair returns on investment but to prevent misuse of resources (in the form of asset stripping or restructuring exclusively focused on survival without attempting the more difficult but ultimately more rewarding changes required for growth).

Corporate governance is critical in the allocation of capital. The stampede to invest (up to 1997) in the countries of east and south-east Asia where there were little or no corporate governance controls, bankruptcy laws, etc. is amazing in retrospect. Unfortunately, in practice, where regulation is most needed, governments are least able to supply it. Even where new owners are contractually committed, the contracts have not been enforceable, as in former east Germany. The Workshop participants made the following three recommendations:

- *Protection of investors is one of the key elements of the business environment that should be in place prior to privatization in order to ensure effective corporate governance.*

In the absence of sufficient legal protection for minority investors, new owners (especially if insiders) may find it more profitable to loot and divert assets rather than restructure. It is also important that the privatization process be perceived as legitimate. Otherwise, it becomes difficult to attract outsiders, as well as to sustain restructuring and avoid backtracking. To ensure an incentive structure favourable to restructuring, further regulatory changes are necessary to enhance flexibility and facilitate social changes. In particular, early introduction of competition and hard budget constraints put effective pressure on owners and managers not to postpone restructuring.

- *The initial privatization methods should be designed to promote restructuring, including facilitation of post-privatization ownership changes that enhance restructuring. Participants commended the example of Poland's National Investment Fund programme, which ensured effective corporate governance of the companies involved and restructuring being undertaken by the fund managers.*

Second-stage asset reorganizations (ie. based on share trading, takeover or other substantial changes in control rights after the initial change in ownership rights) have generally turned out to be much more difficult than envisioned. Early privatization decisions that do not lead to restructuring are hard to unravel. The initial privatization design should explicitly prevent individual or collective blocking of resale of shares to outsiders. Where insiders block changes of ownership, the government may force the issue by converting unpaid taxes to equity and selling shares to new owners.

- *The recommended policy choice for restructuring is to combine transparent corporate governance rules with direct sales to strategic outsiders wherever possible.*

Investors with a strategic share have comparatively stronger incentives to bring in appropriate restructuring agents. In addition, foreign outsiders bring new techniques of production and help implant new standards of corporate governance. Resistance to foreign ownership might be overcome by attaching greater visibility to appropriately-sequenced secondary methods.

D. Capital markets

During the last decade, there has been a dramatic expansion of the capitalization of emerging stock markets, from \$500 billion in 1988 to over \$2.2 trillion in 1997. One of the factors behind this expansion has been the use of domestic stock markets for the privatization of large SOEs, sometimes with dual listings in stock markets in the advanced countries. Telecommunications and other utilities, banks, toll roads, ports and oil companies have been sold, and often recapitalized, through public issues. The growth of pension funds is also helping to channel a flow of domestic savings into the stock and bond markets. The Chilean model of universal individual retirement savings accounts has been emulated in Argentina, Mexico, Bolivia, Peru, Hungary and Poland.

Following the financial crisis of 1997/1998, emerging stock market capitalization plunged, forcing up the cost of capital to privatized enterprises. Future scenarios depend on assumptions about the extent and speed of institutional reforms in the affected countries, such as systems of prudential supervision of the financial sector, avoidance of conflicts of interest by banks which lend to enterprises in which they also hold equity, better debt management, greater transparency in external account positions, and greater sensitivity to profitability in resource allocation decisions. One outcome of the crisis is that governments are far more willing than before to allow foreign investment in their financial sectors and (in Korea, for instance) foreign investment generally. The growth of pension funds will also create more pressure on corporate managers to produce good returns.

- Participants recommended that governments promote stock market listings of large capitalization companies such as telephone companies, utilities and national banks, which attract foreign portfolio investors. Pension schemes should be promoted which will add to domestic savings and assist the development of domestic stock markets. Governments should avoid giving guarantees to investors, except in relation to factors over which governments have control. Nor should they maintain fixed foreign exchange rates where they may be subjected to massive speculative pressure. Governments which offer generous tax incentives to foreign investors should be aware that these do not make investments in their countries more attractive, since double taxation agreements have the effect of passing the benefit to the government in the investor's home country.

E. Political economy of privatization

Privatization is fundamentally a political process about winners and losers. To ensure its success, a way must be found to identify a sufficiently large number of winners and to gain their support. To this end, policy makers/politicians can bluff, learn from other experiences ex post, or conduct ex ante analysis of potential winners and losers. Experience and evidence suggest that bluffing does not work. Ex post analysis can be useful. And, ex ante analysis is best, especially for large utilities.

National privatization programmes are rarely evaluated independently on their outcomes. Their impact on stated national objectives such as economic efficiency and growth is not adequately known, nor the distribution of net benefits, ie. who gained and who lost. More often, policies and programmes are self-evaluated on process criteria, such as numbers of SOEs sold, or the gross proceeds accruing to the national exchequer, and pronounced by the political directorate to be very successful. *Ex post* evaluation replaces prejudices and opinions with facts. The methodology is to compare the stream of costs and benefits following the decision to sell an enterprise with the stream of costs and benefits that might reasonably be assumed to have occurred if the decision had not been made (the counterfactual case). The analysis then determines who (domestic investors, foreign investors, consumers, employees, the government) bore the costs and gained the benefits and who were net gainers or losers. In the World Bank publication, *Welfare Consequences of Selling Public Enterprises*, out of 12 enterprises (not a random sample), 11 showed net gains overall, taking a long-term view. However, the gains were unequally distributed, and some groups lost in some cases. Consumers lost in five cases (out of 12). Governments lost in three cases. Domestic buyers and foreign buyers, who do their homework before investing, each lost only once. In no case were employees worse off, because of labour protection policies.

Ex ante evaluation of privatizations is proposed as an aid to achieving politically acceptable and sustainable distributions of costs and benefits. It recognizes that the distribution of gains is important in itself, that political bluff is not a sustainable strategy and that the prospect of losses by certain groups can block the privatization process or even reverse it. *Ex ante* evaluation uses the same cost-benefit methodology as is conventionally used to evaluate large investment projects. The impact on each stakeholder of alternative policies, eg. with regard to social safety nets, employee share allocations, sale or share issue price, and regulatory regime, can be calculated and assessed before irreversible commitments are made. Though it is theoretically possible to design privatization so that all stakeholders would gain (if projections are realised), this is not always politically feasible. Moreover, win-win outcomes are not necessarily desired, as it may be necessary to use the privatization process to correct some preceding maldistribution. For instance, consumers of State-owned public utility services commonly pay less than the social cost of their consumption, due to deliberate subsidization. Privatization may then be used to raise utility tariffs to levels at which costs are fully recovered, as in Malaysia. In each case, all stakeholders should have access to the analysis and the assumptions on which it is based, so that negotiation can take place on a better factual basis and in a transparent manner.

- *Participants recommended the use of ex ante analysis of impacts on stakeholders of draft policies and proposals on individual privatizations, and explicit analysis of environmental impacts. Open bidding is recommended to ensure the government gets the best possible price. Buyers should get assurances against expropriation of assets or quasi-rents. Workers should be adequately compensated. Consumers should have the assurance of clear pricing policies for monopolies and commitments to investment.*

F. Mobilization of support

Public support smoothes the process of privatization and reduces the risk of failure. Yet few countries have any institutional and policy arrangements in place to mobilize such support, whether domestically or abroad. A public support programme may include policy statements on objectives and methods of privatization and regulation, including criteria for selection of public enterprises for sale and for evaluation of bids, a public awareness campaign to inform and gain acceptance, marketing initiatives to build demand for shares of privatized enterprises (especially where the government aims for broad-based shareholding), road shows for foreign investors, public relations and news releases by the privatization agency, and special programmes targeted to public enterprise employees, trade unions, the media and influential groups in civil society, civil servants and the business sector.

Public-private collaboration in formulating privatization policies and procedures and in monitoring the process promotes the participation of stakeholders and their acceptance of the outcomes. Where acceptance depends on the perceived distribution of benefits, *ex ante* analysis, as mentioned above, may be used to illuminate the impact on stakeholders of variations in policy (where policy is not set in concrete) or at least to correct wrong perceptions. Exposure of critics such as union leaders to their counterparts in other countries which have travelled the same road may also be a key strategy in reducing ideological objections and opening minds to viable options. Privatization should be not only politically desirable and feasible, but also credible. If the government is consistent and transparent in its statements and behaviour, government assurances will be credible. The sequencing of privatizations is also important for building public support. Early visible success creates a pro-privatization constituency: some governments have started with large public utilities where they are confident that major operational improvements can be made under private management.

- *Participants recommended that governments develop suitable institutional arrangements and policies to mobilize and sustain support for privatization, adopt a transparent, fair and equitable approach to the management of their privatization programmes, and explicitly consider the communications, public relations and marketing infrastructure.*

A. Social impacts and safety nets

Experience has shown the importance of protecting vulnerable groups through cost-effective and sustainable social safety nets for short-term protection from the possible adverse effects of reform measures. These include loss of jobs (frequently jobs which are the only source of income of extended families), reduction in pay (more particularly at lower levels), loss of real income due to rising consumer prices (whether due to the ending of subsidies or the failure to control private monopolies) or reduced prices to suppliers (such as farmers formerly protected by administered prices). Privatization can have major impacts on the incidence of poverty, on the distribution of income and wealth, on inter-ethnic disparities and on interregional differences within a country, both in the short term and in the longer term. In some countries, privatization is associated with further concentration of power among the political and business elite, often by corrupt means. Women have suffered disproportionately, as they have often been the first to be laid off. Moreover, privatized enterprises have closed the facilities such as day-care centres which have enabled high female participation in the workforce of transitional countries. Formerly neglected, these social impacts now figure prominently in structural adjustment programmes. Measures include food subsidies, social security schemes and targeted public works, and merge with wider policy responses to economic adjustment generally.

In assessing short-term employment effects, it is necessary to include layoffs before privatization, as well as after. Employment effects start with the announcement of intended privatization, or even earlier, as in the United Kingdom nationalized industries. If privatization is accompanied by a more competitive environment and/or a hardening of budget constraints, the unemployment impact is more severe.

Some countries have given time limit employment guarantees, eg. Sri Lanka, Malaysia, and Pakistan. These have worked well in some enterprises where the expansion of operations after privatization, together with normal attrition by deaths and resignations, has enabled the enterprise to absorb redundant employees within the period of the guarantee. In effect, the government puts the cost of adjustment onto the enterprise, accepting lower proceeds of sale in exchange for avoiding severance payments and the social costs of additional unemployment. However, the majority opinion is that failure to face up to labour problems at the outset may have the effect of crippling the enterprise and preventing turnaround of its performance. Where employment is guaranteed, it is important to ensure sufficient managerial flexibility in internal redeployment and training.

The preferred strategy for retrenchment and redeployment is often a package of severance payments for voluntary early retirement, retraining for new jobs, and job counselling. The

international financial institutions now provide loans for such safety net packages as well as technical assistance. In offering early retirement, it is important not to precipitate the loss of key personnel, who may be glad to accept a golden handshake, then be re-hired later by the same firm or another. Retrenched employees may use severance payments to start their own businesses, so advice on business start-ups should be part of the package on offer. Preferential share allocations, employee share ownership plans and loans for employee buy-outs are also widely used to buy worker support, though these apply mainly to those who remain employed. MEBOs are the form of privatization which has minimized adverse social impacts, mainly because insider-run enterprises have not been willing or able to undertake major labour reforms.

- *Participants recommended the provision of social safety nets to those who, through no fault of their own, lose their jobs from privatization, contracting out or any other economic adjustment programme.*
- *Participants also recommended complementary reforms to make labour markets more flexible, promote labour mobility and reduce the indirect costs of hiring labour.*

A. Regulation and the promotion of competition

Competition was defined as a situation in a market in which sellers independently strive for the patronage of buyers. It is the driving force for dynamic as well as static efficiency, both allocative efficiency and technical efficiency. It occurs naturally except where the market fails, for any of four well-known reasons—imperfect competition, public goods, externalities, lack of information.

Deregulation and liberalization of trade are the main strategies to increase competition. However they are not sufficient because markets are segmented by the behaviour of incumbent firms as well as by trade barriers and regulations. Competition policy is not nowadays based on market structure: the proportion of a market supplied by a single producer is not so important as the conduct of that producer or its abuse of market power by (for example) collusive agreements, price discrimination, resale price maintenance, exclusive dealing, refusal to deal and predation.

It was noted that many of the industrialized economies of today built up their industries from behind a protectionist barrier. In Korea, for instance, firms were still subject to competition in foreign markets, and received government support tied to export performance. In Japan, there was plenty of domestic competition.

With regard to monopolies, natural or otherwise, publicly-owned or privatized, the objective is not only to prevent increases in price which are not founded on increases in costs, but also to reduce costs, ie. to raise x-efficiency and dynamic efficiency, and increasingly to meet various

distributional objectives. Prices, costs, quality, variety and access to service are all important objectives. There are trade-offs among these objectives. Regulators may allow a utility a higher price so that it can raise the quality of its product, as in the case of the United Kingdom water industry, or so that it can retain and reinvest profits to extend service provision, as in most public utilities in the developing countries where capital markets cannot provide all the required funds.

Privatization has often outpaced the regulation of monopolies. It was pointed out that competition and the consumer interest have no natural focal point in the typical government structure: ministries of finance prefer to sell monopolies so as to maximize receipts, ministries of industry try to protect local industry and keep prices up, ministries of labour oppose privatizations which would result in lay-offs, ministries of rural and regional development want subsidies for their constituencies, and so on. Thus there is a need for a strong Competition Office.

Regulatory techniques include the abolition of statutory monopolies; the unbundling of monolithic enterprises and subjection of non-monopoly elements to competition; division of monopoly elements into geographic jurisdictions, which can be controlled by regular reporting and yardstick regulation; “Demsetz competition” for the market, ie. the award of limited-period franchises, often at controlled prices; removal of barriers to entry and exit so that markets can be contested; intermodal competition; and regulation of interconnection agreements for rival use of local telephone and electricity networks.

The method of price regulation for a monopoly should: (1) allow a “fair” return to the investor (though not necessarily a guaranteed return, since risk is involved), (2) ensure a “fair” price to the consumer, (3) provide an incentive to the enterprise to cut its costs, (4) be administratively straightforward and non-discretionary, and (5) have low information needs and administrative cost. These multiple objectives are not easy to achieve. Models range in sophistication from that of New Zealand to that of Chile. The general preference among developing countries today is for a variant of the RPI-X price cap formula, for a period of 3-5 years, fixed by a regulatory board which is independent of the enterprises regulated and, as far as possible, of the government. If the regulatory agency does not trust its capacity to set a target for technological improvement and cost reduction (X in the formula), it may contract this out to an independent consultant.

- *Participants recommended that the regulatory framework should be as unambiguous and credible as possible, and completed before privatization of the relevant enterprises. Competition Offices should be able to prevent privatizations that would result in private unregulated monopolies.*
- *The emphasis should be on introducing more competition into each sector, rather than completing sales or generating fiscal proceeds.*

- *Countries should adopt and enforce competition policies to maximize consumer welfare and economic efficiency, focusing particularly on anti-competitive business practices, and applying to all enterprises equally.*
- *Governments should consider contracting out selected regulatory activities.*

A. Valuation of enterprises

Too much time and money has been spent on looking for “correct” or “intrinsic” valuations of enterprises (early Polish privatization valuations for instance), as governments tend to think that valuation techniques offer a route to a scientific and objective valuation, or that the “true value” of an enterprise must lie somewhere within the range of valuations so generated. Not enough attention is paid to developing options for market valuation and transparency. Instead of paying high fees to consultants to get an independent valuation of an enterprise, which is really worth only what someone else is prepared to pay for it, governments should orchestrate a process of getting more bidders to the table and getting some figures to compare.

Nevertheless, since there is a risk of collusion, or of only one buyer making a bid, the government should establish a reserve price, below which it would prefer to postpone divestiture. This also serves to protect the government from accusations that it is giving away national assets. The reserve price has to be fixed in advance of receiving bids, and before the government sits down at the negotiating table, so it has to be based on information other than serious bids. The bidding/starting point can be the nominal book value of the assets. Where the sale is not really about the assets (such as a junkyard of obsolete analogue telecoms equipment), but a concession which grants market access, valuation may then be based on an estimate of market potential (population, urbanization, household incomes, historical penetration rates and profit margins in other countries, etc.). In selected cases, ex ante social valuations may be made. As governments turn more to the privatization of infrastructure, these are the jewels in the crown, which need great care.

Mass privatization schemes have been heavily criticized (with the notable exception of the Polish scheme that used professionally managed national investment funds). This has been mainly due to the speed at which privatization was pushed through (under the window-of-opportunity theory) and the consequent lack of supporting market infrastructure (corporate governance regimes, supervision of investment funds, trading and clearance mechanisms). Minority shareholders, for instance, have little redress against exploitation by majority shareholders. On the other hand, the valuation of enterprises has been transparently determined. Valuation involved nation-wide share auction systems, with repeated rounds of bidding for the

shares of each enterprise by holders of vouchers, so as to establish the marginal price at which supply equated with demand.

The value placed by foreign investors on a public utility depends not only on market-based projected cash flows, but also on the risk of price tariffs being subject to government manipulation, on exchange rate volatility (since all revenues will be in the domestic currency), and on possible exits (such as a secondary share market and convertibility). Investors will examine very closely the government record of involvement in other privatized bodies, and the proposed regulatory infrastructure.

- *Participants recommended more attention to price discovery through market-based valuations and to transparent methods such as voucher-for-share auctions. Sole sourcing and closed-door negotiations should be avoided where possible. Reserve valuations and “political shield” valuations should be based on the nominal book value of assets, except where the sale is really a market concession, when the valuation should be based on market potential, government credibility and exchange risks.*

A. Accountability, transparency and corruption

Corruption is the use of public office for unauthorized private gain. It occurs where there is lack of transparency and accountability. The privatization process is widely seen as a major source of grand corruption. Regulation, though lagging behind, is also seen as a source of corruption, as regulators have power over large and wealthy corporations and it is in the interest of corporations to capture regulators, and in the interest of regulators to be captured. In all cases, corruption has an adverse fiscal impact, as side payments are factored into the price. While the extent of corruption in these areas has not so far been measured, there is empirical evidence that countries which are perceived as most corrupt have lower investment and slower growth, and poverty alleviation is impeded.

Spontaneous privatizations are equivalent to fraud or theft. Apart from these, corruption is worst in trade sales and contracting out. In both these modalities, competitive bidding should be used. Standard procurement documentation should be adapted for use in divestitures. There are still problems, however, with transparent and objective evaluation of bids where they are ranked on prospects for greater efficiency and other subjective criteria. Bidding and evaluation procedures should be known to all concerned, and the results of the process, including all the terms and conditions of each sale, should be publicized.

A prime source of corruption is administrative complexity and ambiguity, which allow administrative discretion and corruption in implementation. In some cases, procedures can be abolished altogether; in other cases they can be

made more prescriptive (less discretionary, though this tends to be at the expense of brevity and simplicity), and involve fewer officials (fewer rent-collecting opportunities).

Many countries lack technical expertise for the privatization process. International advisers can provide not only expertise, but also credibility to the government. The presence of a well-known consulting firm which values its reputation validates the privatization process and sends reassuring signals to doubtful investors.

- *Participants recommended that open and transparent bidding, evaluation and disclosure procedures be used in trade sales and contracting out. For each privatization modality, there should be internationally approved procedures and documentation.*
- *Privatization should be taken out of the hands of line ministries and managed by expert agencies using international consultants as necessary for their expertise and credibility-enhancing advantages, and supervised by the political directorate.*

A. International cooperation

Where national political will exists, there is ample technical and financial assistance available to developing countries and transitional economies from international financial institutions, the agencies of the UN system, non-UN intergovernmental organizations, regional associations, bilateral aid agencies and international NGOs. Both direct operational assistance and capacity-building assistance is available. Governments have sometimes seen privatization as a limited-period exercise and neglected their continuing needs for in-house capacity to manage the interface with the private sector. Sustainable capacity is built through training and institution building, including adoption of international standards of accounting and audit, improvements in tax administration, and establishment of new support institutions, such as capital market institutions.

Secondly, the private sector needs capacity to manage the newly privatized enterprises. In the CEE and FSU countries, most of the post-privatization funding has been channelled into the development of business support institutions (USAID, World Bank, Soros Foundation and others). There have not been major attempts to develop wholesale approaches or methodologies to tackle post-privatization problems in the region. It is critical to invest in the training of managers of privatized firms, otherwise there is a strong probability that they will fail.

Technical assistance draws on the experience of other countries, while each country is very aware of its own uniqueness. Participants agreed that the design of privatization policies and programmes should depend on the specific conditions and a national framework in each country, not on pre-cooked imported models. Privatization is not an end in itself. It should serve explicit national goals, such as economic efficiency and social equity. As a generalization, Organization for Economic Cooperation and Development countries have been more successful in setting privatization within purely national policy frameworks, while developing countries and several transitional economies have been more subject to outside influences, particularly when they have been in external imbalance. Multilateral institutions have often played a determining role, offering technical assistance backed by loan conditions. In such countries, privatization has been seen as an extension of the policies of international financial institutions. Nevertheless, the experiences of other countries, whether generalized or particular, have an educational role. They provide reference points against which national issues and problems can be put in perspective. A prime

role of the international community is to disseminate and share these experiences and whatever lessons from them that may apply to the recipient country. The World Bank is the leading source of comparative research on privatization and regulation; it maintains a clearing house of information on the Web.

Each specialized agency in the United Nations system addresses privatization issues in its own special field, such as the International Telecommunications Union, International Labour Organization, United Nations Industrial Development Organization, United Nations Conference on Trade and Development, International Civil Aviation Organization, Food and Agriculture Organization,

World Health Organization and World Tourism Organization. The international financial institutions (International Bank for Reconstruction and Development, International Monetary Fund, and regional banks) also provide loans for meeting the expenses of privatization, including the social safety nets. Where different agencies provide technical assistance in the same country, they should ensure that they work in coordination, supplementing and reinforcing each other's activities, starting at the planning and programming stage. This is normally achieved through the office of the UN Resident Coordinator in each country. There should also be scope for healthy competition among agencies and the emergence of alternative approaches to problems.

A major role of the international community is to provide a supportive international economic environment and to address transnational issues of privatization through international machinery. One such issue is the bribery of public officials in privatization transactions. The OECD has recently promulgated a convention to combat bribery of public officials by business people from its member countries. The ILO has issued guidelines on industrial relations in the new business environment in globalizing countries. Another issue that needs to be addressed is the establishment of international standards to control international laundering of illicit gains from privatization and corrupt activities.

- *Participants recommended that the international community continue to support nationally sponsored programmes of privatization and regulation through provision of technical skills, methodologies, and comparative analysis of experience, and set international standards in fields related to privatization which will promote the realization and wide sharing of gains.*

**II. GLOBALIZATION, FINANCIAL INSTABILITY
AND PRIVATIZATION**

A. Globalization: definition and comparative experiences

A *strictu sensu* definition of globalization calls for the fulfilment of two critical conditions¹: First, the global economic space is characterized by unhindered and full international mobility of goods and of factors of production. All of them face ample technological and institutional possibilities which permit complete substitutability among them within the world economic space. Second, the governance of such a global economic space is characterized by the presence of organizational schemes which do not simply limit the autonomy and sovereignty of the nation state, but which even question its very existence.

Instead, two complementary organizational schemes take the place of nation states and their functions in economic governance:

Large corporate business institutions become key among private actors who plan their economic performance on the basis of globally defined interests and respond to market opportunities on a worldwide basis. At the same time, local conditions and institutions lose their relevance through a convergence of policies and corresponding rewards. In turn, a uniformity of interests is produced, backed by global business strategies and organizational structures of the corresponding business actors. These corporate practices are certainly facilitated by recent technological changes which have dramatically reduced economic space and economic time. They have also been promoted by historic and across-the-board institutional initiatives of market liberalization and deregulation.

- Certain public goods which are indispensable for the functioning of free markets (e.g. secure property rights, monetary stability, predictability in macroeconomic conditions and practices)

become a global responsibility rather than being controlled by a few dominating national economic powers who set the rules of the international economic system.

These conditions of globalization, though, also display specific characteristics which belong to the sphere of ideological constructs. They can also serve the goals of specific interests and leave unspecified major distributional concerns of power, knowledge and of economic rewards in the world economy. At the same time, critical issues remain unclear, such as the meaning of “global responsibility”, and the definition of “uniformity of interests” as contrasted to the marked presence of divergence instead of convergence patterns in a number of real-life key economic matters.

¹ See UNCTAD (1997), *Trade and Development Report, 1997: Globalization, Distribution and Growth*, Geneva, pp. 70 et seq.

In comparison to the rather loosely defined yet extensively used term “globalization”, an alternative interpretation appears more relevant which acknowledges a presently growing *global international interdependence*. The latter implies, in turn, two fundamental implications which need to be interpreted in the context of the completely new technological and institutional environments presently prevailing. Such implications involve the following:

1. Trans-border flows of goods and services, as well as of factors of production including information, are so prevalent and strong that decisions in one country by government and business agents depend on decisions and evolutions made elsewhere. Such an interdependence does not necessarily depend on uniform globalization conditions but, instead, exists in the presence of a varied geography in economic space worldwide. Such a varied geography implies:
 - an effective globalization in some markets (mainly in capital markets and in information flows);
 - a tendency towards regionalization in other markets (especially in production and trade of goods and services);
 - a strong national basis in strategic assets (such as national educational, science and technology systems, national control in key ownership shares and in the complementarity of strategic initiatives between the respective public and private sectors); and
 - a localization process (e.g. in workers’ training, cultural diversity).
1. Despite the undisputable importance and implications of trans-border flows referred to above, *national* processes of resource accumulation, of institution building and reforms as well as of relevant domestic policy options, greatly influence national performances and the way by which influences from the international environment are affecting local performance and conditions.

The manifestation and implications of growing global international interdependence differ significantly in distinct time periods. Two such periods are significant, namely 1870-1913 and the post-1980 years. Major areas of difference and similarity between the two periods are reported in the relevant literature² on economic performance as follows:

² See references in Williamson, J. (1996), “Globalization, Convergence and History”, *The Journal of Economic History*, vol. 56, no. 2. Also, Maddison, A. (1995), *Monitoring the World Economy*, OECD, Paris. Baumol, W. (1986), “Productivity growth, convergence and welfare: What the long-run data show”, *American Economic Review*, vol. 76. For a critical review see UNCTAD (1997).

Trade activities

The ratio of exports (X) to GDP on a worldwide basis increased by almost 80 per cent during the period 1870-1913. Such a phenomenal increase raised the global X/GDP ratio from 5 per cent in 1870 to close to 9 per cent by the beginning of the first world war. Sixty years later, at the beginning of the 1970s, the corresponding X/GDP ratio had reached about 12 per cent. After the surge noted in world trade activities from the early 1980s, with a critical role played by trade liberalization and by the expansion of activities of transnational enterprises, exports to GDP reached almost 17 per cent by the mid-1990s. Subsequently, a slowdown was registered due to not only the relative slowdown in aggregate growth patterns in the world economy during recent years, but also since the impact of trade liberalization policies had already been incorporated in the trade performance of the 1980s and early 1990s.

It is important, though, to note that significantly more than 80 per cent of world production still attends local market needs. This percentage is even greater in the activities of state-owned enterprises in public services in which privatization interest has been expressed during recent years.

Transborder capital flows

Both periods are characterized by significant volumes of international capital flows which, though, differ in fundamental ways with respect to their composition, objectives and financial stability/instability impacts. During the 1870-1913 period, the overwhelming majority of such trans-border capital flows took the form of long-term government bonds. This provided a significant degree of built-in financial and other macroeconomic stability. In contrast, the surge of capital flows during the last two decades has been dominated by highly volatile short-term financial movements by private sector institutional and other investors.

The proven instability of the latter flows have affected key macroeconomic and real economy conditions of the "host" countries. As a result, longer-term productive capital flows, like those involved in privatization, have often been hindered, at least as far as their timing is concerned. Even worse, the terms of investment into countries forced to privatize under stress have also been greatly influenced. At the same time, expectations of privatization proceeds (as the recent Brazilian experience has shown) have contributed to policy making leading, over the medium run, to financial instability provoked by short-term capital movements.

Furthermore, transborder capital movements during the period 1870-1913 were tied to trade activities which played a key role in capitalist development in certain countries. They also represented a major component of gross fixed productive capital formation in the receiving

country and, thus, served to expand significantly the latter's productive capacity. For example, mainly British capital flows accounted for 40-50 per cent of gross fixed capital formation in countries like Sweden, Argentina, etc. at the turn of the century, thus playing a key role in infrastructural development.

In contrast, the recent trans-border capital flows are dominated by strictly finance capital interests. Daily, they shift extraordinarily huge amounts of capital under arbitrage criteria so as to take advantage of interest and exchange rate differences. Productive capital inflows, especially in developing countries, are significantly less than 5 per cent of gross fixed capital formation and only exceptionally rise to the level of 10 per cent. During the period 1988-1994, capital inflows linked to privatization were reported to be less than 2 per cent of foreign direct investment in South-East Asia, 6.4 per cent in sub-Saharan Africa, 15 per cent in Latin America and 43 per cent in Eastern European and Central Asian transition economies³.

Labour movements

Migration flows proved to be a key feature of the earlier experience in growing global interdependence. During the period 1881-1915, 32 million Europeans migrated to North and South America, Australia, etc. Additional flows involved labour movements from China and India. Labour movements in those years affected trends in real wages and per capita income in both home and host countries. Nowadays, all industrialized advanced countries apply strict immigration rules, thus, excluding labour from the growing global interdependence.

Organizational/institutional schemes

The underlying organizational/institutional support mechanisms for growing global interdependence in the post-1870 period included the gold standard and currency zones on monetary matters, major conventions on intellectual property protection and, above all, colonialist exploitation. In more recent times, the Bretton Woods institutions were established right after the second world war, yet initiatives linked directly to the underlying phenomena of present day global interdependence are dominated by two fronts: first, the reform of the GATT with the Uruguay Round agreements on trade of goods and services, investment matters (TRIMs), intellectual property issues (TRIPs), etc., have set the institutional foundations and requirements for liberalization, deregulation and property rights protection on a global scale. Second, the absence of major multilateral initiatives to control financial instability provoked by short-term capital movements serves to underline the weaknesses of Bretton Woods institutions in confronting present-day needs on a global scale.

³ See references and analysis in Vaitsos, C. (1998), *Guidelines on Privatization and Public Enterprise Reform*, Document prepared for the European Commission, DG VIII.

Convergence/divergence patterns

Very few countries, mainly the economies of Western Europe and some elsewhere in the world (i.e. Argentina, Australia, Canada), followed a convergence path under the special circumstances of the post-1870 years. In most other cases, though, growing global interdependence was concomitant at that time with increasing divergence in economic performance. On the whole, the major difference between sustained success and failure in a highly internationalized economic context of that period had to do with the introduction of *domestic* institutional reforms. The latter were promoted by a modernizing developmental state. The role of the state proved to be central in establishing and securing certain critical capitalist institutions (in property rights, market conduct and diverse market institutions), in educational reforms, infrastructural activities and in promoting active industrial, trade and technology policies.

In present-day global interdependence, a few latecomers, especially in South-East Asia under active development policies, have registered impressive catching-up trajectories with sustained high-growth performance over several decades. At the same time, though, growing economic interrelations on a worldwide scale have again been accompanied by increasing divergence in average income, productivity and other indicators. Such divergence patterns are noted between and within national economies, between capital and labour earnings, between different earnings from work, and between finance and productive capital. Furthermore, global interdependence coexists with major phenomena of exclusion and of polarization.

B. Privatization issues

*Definitions of privatization*⁴

A narrow definition of privatization involves the transfer from the public to the private sector of *entitlements to residual net cash returns* generated from operating business enterprises. Asset sale or divestiture can, but need not be, involved. Other forms include the transfer of control over operations, the transfer of management, contracting out, diverse BOT arrangements, etc.

A broader and more relevant definition of actual practices perceives privatization as *rebalancing the role of the state*. Such a rebalancing involves three main areas:

- *Exit* of the state from production and trade activities in commercialized goods and services;
- Intensified state commitment in *enabling* the expansion and competitiveness of private-sector activities; and

⁴ See also United Nations (1999), *Privatization of Public Sector Activities*, Department of Economic and Social Affairs, New York.

- *Policy and regulatory functions* so as to: promote dynamic efficiency and foster competition; strengthen market stability and predictability; protect consumers and the environment; and advance socioeconomic cohesion.

Economic governance issues

The reduction of public sector participation in commercialized production as well as the correction of government failures and of bureaucratic impediments, call for more (not less) capacity for governance. In such privatization requirements, the following issues assume special importance:

- The activities involved are intensive in the presence of *institutions*. Institution building is, in turn, a location-specific commitment. It can be assisted but not transplanted from other locations and experiences;
- Economic governance in privatization is a *process involving the use of capabilities*. As such, it does not constitute an isolated transfer of ownership of control, etc. Rather it commences well before the actual negotiations on the transfer of business entitlements and continues afterwards through monitoring and regulatory practices; and
- The governance of privatization needs to take into account that it constitutes, in effect, a dual process: it is an intensely *political process* since it redistributes power (economic and political) and involves conflict resolution between net winners and losers. Furthermore, privatization is intensive in public communication requirements and sensitive to public opinion trends. Privatization is also a demanding *business process* when it comes to implementation. This calls for a number of key technical and operational initiatives that need to be carefully programmed and managed. These include⁵: initiatives prior to privatization; assuring the presence of enabling legal and institutional conditions; institutionalization of the privatization process; providing for supporting institutional requirements; and organizing privatization execution in terms of preparation, implementation and monitoring.

⁵ See UNCTAD (1995), *Comparative Experiences with Privatization: Policy Insights and Lessons Learned*, Geneva. Also, World Bank (1997), *The Privatization Challenge: A Strategic, Legal and Institutional Analysis of International Experience*, Regional and Sectoral Studies, Washington, DC.

Overall approaches on privatisation

Privatization experiences in a number of industrialized economies have been based largely on national policy criteria and corresponding decisions, and for that reason they differ from country to country. These have set the institutional and other rules within which privatization advanced while also benefiting from other international experiences on these matters. In contrast, in most developing countries a determinant role in privatization has been assumed by the multilateral financial institutions. The latter have come to monopolize actual privatization initiatives and have been supported by a panoply of special financial and technical assistance provisions, backed by the conditionalities framework of debt settlement.

Two overall approaches are at issue. First, the prevalent approach relies fundamentally on the instruments of capital markets and delegates execution responsibility to specialized financial institutions, like the investment banks. This financial orientation is a key feature of the policy recommendations by multilateral financial institutions⁶.

An alternative approach, often supported by the continental European experience⁷, has a more comprehensive orientation which tends to be more programmatic and negotiated. In effect, it sets a broader contractual base to assist in

reaching an agreement among distinct stakeholders in the privatization process. While also relying on the instruments of capital markets, this more comprehensive approach has three attendant policy concerns:

- It gives preference to integrated *sectoral strategies* with a longer-term development perspective, instead of relying on purely financial criteria that place emphasis on immediate private returns and public revenues.
- Special attention is given to *regulatory practices* in critical public interest concerns, especially in public services. Governments should be aware of important regulatory failures and the requirements posed for

⁶ See Ferreira, D. and Khatami, K. (1996), *Financing Private Infrastructure in Developing Countries*, World Bank Discussion Paper No. 343, World Bank, Washington, DC.

⁷ See Groupe de la Caisse Francaise de Developpement, (1997), *Privatisations et Developpement*, Paris.

- institutional building linked to regulatory initiatives.
- A minimum explicit yet critical concern is required on strategic *macroeconomic implications* of privatization practices, with special reference to: social cohesion and employment needs; political and economic power relations; and spatial integration matters.

Finally, it needs to be acknowledged that quite different perspectives are often involved in actual privatization practices. Economists and business analysts are mainly preoccupied with micro-efficiency matters and growth implications. Policy makers often focus predominantly on fiscal considerations. Politicians and other stakeholders pursue in turn their own goals, largely linked to distributional matters.

III. CORPORATE GOVERNANCE AND RESTRUCTURING: POLICY LESSONS FROM TRANSITION ECONOMIES

A. Introduction

The debate on corporate governance, receiving renewed popular attention following the turmoil in emerging markets, dates back at least to Adam Smith within the context of the foundation of modern companies in Anglo-Saxon jurisdictions. The debate has centred on how larger enterprises that require substantial external finance should organize themselves. What type of corporate form of organization best allows economies of specialization from skilled managers using resources that are actually mobilized or owned by others (banks and shareholders)? Smith criticized managers' negligence as well as the absence of control by incompetent and uninformed investors, two themes developed and refined since then. According to Berle and Means (1932), the separation of ownership and control may cause a divergence of owners' and managers' interests in the absence of any effective monitoring of the power of managers. The policy debate itself has since broadened, with commentators arguing that differences over how to achieve good governance may be driven by differences over objectives: is the goal of corporate governance to increase returns for shareholders or for a broader group of stakeholders, to prevent corruption, to improve social welfare, or to do all these things?

From an economy-wide perspective, different forms of corporate governance can conceivably have an

important impact on how resources are employed, and hence on growth and national welfare. In practice, policymakers should pay attention to whether the prevailing business environment leads to appropriate control structures within enterprises to ensure

that management implements decisions correctly based on signals from product and input markets. The recent experience of transition economies with varying approaches to privatization and business rules provides a fertile context for examining the effect of corporate governance on resource use and re-deployment.

This paper examines the relevance of corporate governance for enterprise restructuring. Within this context, particular attention is paid to policy implications for the design of appropriate privatization programmes. Section B reviews the corporate governance problem and its relevance for restructuring. Section C then examines the experience of transition economies, in particular the links between ownership structure as influenced by privatization design, the broader business environment, and restructuring outcomes. A final section concludes with policy recommendations. The recommended privatization method to promote desirable restructuring decisions includes a combination of direct sales to strategic outsiders, where feasible, and transparent corporate governance rules. It is important that the initial privatization design and prevailing corporate control environment is structured to facilitate changes in enterprise ownership and control. Importantly, key elements of the business environment—including rules and institutions to ensure hard budget constraints and to promote maximum competition—should be in place prior to or concurrent with privatization. Finally, a continuous public education campaign should be undertaken to educate concerned enterprises and the population at large about the requirements and benefits of restructuring, and the role of effective corporate governance in that process.

B. Corporate governance and its links to restructuring

The corporate governance problem

Corporate governance includes all incentive-based mechanisms (based on laws, regulations and voluntary practices) to ensure that providers of external finance have sufficient *control* rights to effectively influence managers in order to get an *appropriate return* on their investment. The first part of the definition implies that financiers should be able *ex ante* to select managers and *ex post* to monitor, influence and replace managers if necessary. The second part implies that corporate governance rules should prevent managers' actions from conflicting with the legitimate interests of financiers while ensuring as far as possible a productive alignment with the interests of other stakeholders.⁸ The primary control objective can only be accomplished by ensuring cooperation of the other relevant stakeholders who are able to negatively affect the internal operations of the corporation. That is, firm-specific suppliers and customers, municipal governments, employees and other affected members of the community should also be provided incentives to align their objectives with those of the corporation. Whether these potential conflicts of interest are more or less critical than the ones between managers and financiers probably depends on the specific enterprise performance, control structures and institutions prevailing in individual countries.⁹ For instance, the opposition of employees and other stakeholders can play an important role when major changes take place in the corporation, precisely when privatization and subsequent restructuring decisions lead to significant redundancies and plant closures in environments where alternate sources of employment are scarce.

⁸ This agency perspective is based on the contractual view proposed by Coase (1937). Corporate firms integrating different activities were considered an alternate solution to the use of markets and long-term contracts to overcome the problems associated with imperfect and missing markets, by providing a device for gathering the needed amount of human and physical capital. This view has been refined under asymmetric information as the optimal incentive contract theory by Mirrlees (1976). On managers' misuse of residual control rights there is an extensive literature dating back to Baumol (1959), Marris (1964), Williamson (1964).

⁹ The traditional emphasis on conflicts between managers and financiers is at least in part due to their ongoing, more continuous relationship with the corporation and the lower risks they bear given that they do not provide substantial finance. Note that such conflicts in principle include conflicts between managers and important shareholders/debtholders as well as between owner/managers and minority investors when the firm is closely held.

The corporate governance problem as defined here cannot be easily solved unless the prevailing environment is characterized by relatively complete contracts and credible commitments. In practice, contracts are often incomplete with costly enforcement and monitoring. In addition, it is often difficult for relevant stakeholders (owners, managers, employees, suppliers and buyers, municipal and central government agencies) to make the credible long-term commitments required to attract sufficient financial and human capital for the corporation to perform efficiently. These market imperfections raise additional costs in connection with the monitoring that is essential in order to avoid managers' pursuit of self-serving actions which are opposed to the interests of the company's residual claimants.¹⁰ The problem associated with contract renegotiation becomes more severe when restructuring is under way, since managers, local authorities and other influential stakeholders then have even stronger incentives to behave opportunistically, anticipating that firms will either be closed or drastically restructured.¹¹

By focusing on the broad control rights of providers of external finance, irrespective of whether they are holders of equity or debt, and by linking these control rights to other stakeholder interests, this definition extends the traditional emphasis from a control focus on the internal division of powers between the bodies governing the corporation (executive managers versus shareholders and boards of directors) to broader considerations of multilateral negotiations and influence-seeking.¹² Importantly, differences between investment in equity or debt are likely to be more significant for firms in the process of restructuring. Debt-holders are particularly concerned with opportunistic behaviour by managers (ie. that funds are used unwisely or entirely disappear) when the collateral rapidly depreciates or returns have the potential of coming in relatively quickly, both typical of radical changes facilitated by an external infusion of capital.¹³ Another circumstance that makes debt

¹⁰ Managers may: (i) be more risk-averse than shareholders, having more to lose from failure; (ii) reach decisions that are acceptable to insiders within the organisational group instead of maximising profit; and/or (iii) pursue self-preservation policies by creating barriers to takeovers or to the entry of strong investors.

¹¹ It should be noted that the focus of this paper is not on large enterprise restructuring of strategic sectors of the economy.

¹² The standard literature was largely limited to formalizing the decision-making process within a company, defining the role of shareholders, and the appointment of their representatives to the board of directors.

¹³ Lenders can ensure a balance between the outstanding debt and the remaining value of the project including the collateral (i.e. the resale value of company's assets) only if the loan is well supported by

financing less attractive is when creditors experience difficulties in collecting through bankruptcy proceedings—a risk that is particularly strong in transition economies and which therefore needs to be compensated by even higher premia. Equity finance is therefore likely to be more attractive for restructuring enterprises. However, equity finance also is likely to pose more challenges. First, existing owners must be willing to trade relatively less expensive financing for possible loss of control. Second, equity holders will need even more protection, especially if they are small investors since they remain more exposed to the risk of expropriation of dividends by the firm's management.

Internal mechanisms of governance should ensure that corporate decisions reflect the interests of majority and minority shareholders. They can be summarized by three overriding principles of good governance: accountability, probity and transparency.¹⁴ *Accountability* of management and boards to owners is reflected in the set of basic shareholder rights, including equitable treatment of minority shareholders. Such rights should include self-enforcing rules that allow minority shareholders to scrutinize and enforce the duties of care and loyalty owed them by directors. Rules should typically include requiring prior shareholder approval for the purchase or disposal of substantial assets, and having a sufficiently low threshold at which large shareholders must offer to buy out minority shareholders. *Probity* is reflected in clear rules outlining the monitoring responsibilities of appointed boards of directors to the company and its shareholders. These obligations should include a duty to act in the best interests of the company and neither to self-deal nor to vote on transactions where there may exist a personal interest. Finally, *transparency* and disclosure are reflected in rules to improve the flow of information within the company to the board (so the board can monitor management) and from the company to shareholders (for shareholders to evaluate management performance). Rules should include an obligation to disclose financial statements and annual reports, and various formalizations of the independence of external auditors.

assets and if the flow of returns is fairly predictable.

¹⁴ As emphasised by Bob Garratt, visiting professor of corporate governance at London's Imperial College, who helped write the October 1997 draft code for the Commonwealth Association for Corporate Governance (CACG). These are also reflected in OECD's Draft Principles of Corporate Governance (1999), which cover the five areas of (I) The rights of shareholders; (II) The equitable treatment of shareholders; (III) The roles of stakeholders; (IV) Disclosure and transparency; and (V) The role of the board.

External mechanisms of governance generally involve the additional discipline on managers and large shareholders coming from the threat of stock sell-offs and takeover (outsider shareholder monitoring through exit or ownership consolidation) and from the threat of bankruptcy (creditor monitoring). In a typical hostile takeover, a bidder makes an offer to the dispersed shareholders of the target company and can thereby acquire management control.¹⁵ The power of large creditors comes from a variety of control rights that they receive if companies violate debt covenants or default, including foreclosing on collateral and pressing for bankruptcy or liquidation. In many countries, banks end up holding equity as well as debt, or alternatively vote the equity of other investors (blocks of shares). Banks can play a major governance role in bankruptcies when they change managers and directors. The effectiveness of creditor monitoring depends on the extent of support for creditor rights in the legal system, including the power to pull collateral, and the discretion and capabilities of administrators, judges and courts.

There appears to be substantial consensus that good governance systems should involve a *combination of large investors and substantial legal protection of all investors*, large and small.¹⁶ The intuition behind the importance of having large investors goes as follows. The free rider problem associated with monitoring managers under dispersed ownership can be quite substantial because of the high costs of gathering information on managerial behaviour compared to the low potential incremental benefits and the small likelihood of impact on corporate decisions. From this it follows that where the corporation underperforms, small investors will have a strong incentive to take a short-term view and sell their shares rather than play an active role in monitoring to maximize the firm's long-term value. Large shareholders, in contrast, directly address the agency problem by having an interest in profit maximization and enough control over the assets to have this interest respected. When control rights are concentrated in the hands of a small number of investors with a collectively large cash flow stake, concerted action is easier than when control is dispersed. Even if costs associated with monitoring remain substantial, the benefits and influence on internal decisions are significantly higher.

¹⁵ Takeovers and concentrated ownership are substitute mechanisms of corporate control since more widely-held ownership makes stock markets more liquid and facilitates takeovers. See Bolton and von Thadden (1998).

¹⁶ See Shleifer and Vishny (1997).

Given the relatively low levels of legal protection of investors in many countries, it is not surprising that the United States-United Kingdom model of widely-held ownership and arms' length finance is uncommon. Widely-held firms are extremely rare, even in countries that opted for mass privatization through vouchers. Instead, the prevailing pattern, as documented by La Porta et al. (1997) based on a survey of ownership structures in 27 economies, is closely-held firms with a dominant shareholder, where the controlling families directly participate in the management of companies they own.¹⁷ Based on these findings and a focus on the issue of control by financiers, La Porta et al. argue that the principal agency conflict in most countries is not between managers and controlling owners but rather between controlling and minority shareholders.

Improving the legal environment so as to protect minority shareholders can be important in several dimensions.¹⁸ First, strong protection for minorities reduces the scope for rent extraction by large investors or other controlling stakeholders (generally the entrenched managers), which arises from two main sources: (1) direct expropriation, namely attempts by the controlling stakeholders to treat themselves preferentially at the expense of other investors and employees by diverting resources directly to themselves through additional special dividends or other forms of more or less covert expropriation and (2) owner self-aggrandizement or managerial slack, namely reducing the efficiency with which the firm's assets are deployed by the controlling stakeholder pursuing personal objectives that do not maximize company profits. A second benefit of minority protection is to prevent the counter-productive but rational behaviour of other insiders (non-controlling managers and other employees), who otherwise would be induced to distort their own firm-specific human capital investments in response to the controlling stakeholders' ability to extract rents. Finally and probably most importantly, potential minority investors that are unprotected will be unwilling to invest, raising costs of access to external finance from both domestic and foreign sources.

While there appears to be a consensus on the importance of protecting investors, especially where strategic investors are needed to restructure recently-privatized enterprises, the relative emphasis on minority protection *per se* is still an open question.

¹⁷ On average across 15 countries with poorer shareholder protection, 34% of the largest and 50% of mid-size firms are family-controlled. Across all countries and firms surveyed, at least 69% of the time families that control firms also participate in management.

¹⁸ See Shleifer and Vishny (1997), especially section V, 'The costs of large investors'.

As emphasised by Berglof and von Thadden (1999), our understanding of how to preserve the incentives of owner/managers in family firms while strengthening the protection of minority shareholders is rather limited. On the other hand, in transition economies one of the key problems is how to introduce new incentive mechanisms rather than preserve the incentive structures of incumbent owners/managers when they do not lead to socially-desirable outcomes. Notably, within the context of the broader stakeholder view of corporate governance (that takes into account other groups inside and outside the firm that exert influence on enterprise decisions), such objective can be achieved through reinforcing—or in many instances introducing—other mechanisms such as increased competition and pressure from suppliers and customers to help compensate for weaknesses in internal governance.

The relevance of corporate governance for restructuring

Improved corporate governance is a vehicle for a number of possible objectives. The focus here is on how corporate governance interacts with growth-oriented restructuring at the enterprise level. Restructuring is characterized by radical, non-marginal changes in production techniques, implying non-marginal changes in factor mix and output mix. Market-based restructuring actions generally involve both survival-driven changes to reduce costs and growth-oriented changes to increase revenues.¹⁹ In those instances where the existing asset mix has a more desirable alternate use, this may require rapid enterprise exit and resource reallocation to other enterprises. While useful as a first step towards growth-oriented restructuring, survival-driven changes are harmful to the extent that they are motivated solely by a desire to postpone or block further socially-desirable adjustment.

Effective corporate governance affects growth-oriented restructuring by ensuring that appropriately skilled implementing agents are chosen and that appropriate actions are implemented while respecting the finance constraint (sufficient finance) and the political economy constraint (socially legitimate process). There are four main channels. First, corporate governance ensures the selection of the *appropriate restructuring/turnaround agents*. Owners should be able to replace managers if necessary, and

¹⁹ Restructuring requires *inter alia*: (1) profit/shareholder value maximization as the objective of owners; (2) human capital/expertise to identify profitable opportunities and (3) substantial new finance to implement the required changes. Alternative terminology includes reactive or defensive for survival-driven, and deep or strategic for growth-oriented. See Carlin (1998) for an overview of this two-stage approach to restructuring.

appoint individuals most skilled at the specific restructuring challenges that the enterprise faces (having industry-specific knowledge, together with marketing, accounting and finance skills). A second channel is ensuring that managers take *appropriate restructuring decisions*. Owners should be able to leave sufficient discretion to managers in their technical decisions regarding changes in resource use and the structure of outputs, but require managers to report periodically and relatively frequently initially regarding the technical bases for decisions and ongoing results. A third channel is attracting and retaining *sufficient external finance* needed for restructuring. In addition to helping enterprises get access to funds beyond internally-generated sources, protection of investors helps insulate the enterprise from sudden outflows.²⁰ A fourth channel is ensuring a *broad social legitimacy* for the restructuring process. Restructuring generally involves winners and losers, or at least a non-uniform distribution of gains. Without a governance mechanism widely perceived as appropriate, with stakeholders adequately protected, unavoidable resistance by the potential losers may become impossible to overcome.

The first two channels ensure that a desirable ownership and control structure is put in place, whereas the last two ensure the sustainability of the restructuring process. In practice, successful growth-oriented restructuring across a number of enterprises throughout the economy should be reflected in increased productivity, increased foreign direct investment flows (reflecting profitable investment opportunities), and more gradually in increased export earnings in tradable sectors. Over time, as resources are reallocated to growing new and restructured enterprises, expected outcomes include higher employment, income, consumption levels and sustainable growth.

Improved alignment of the interests of owners, managers and other stakeholders within the enterprise is only one of a number of areas of the prevailing *business environment* that can stimulate appropriate restructuring.²¹ Additional measures to strengthen discipline and prevent enterprises from being shielded from adjustment pressures include eliminating soft budget constraints (unconditional subsidies to loss-making enterprises) and strengthening product market competition (eliminating anti-competitive government and private sector practices, with a special focus on reducing

entry barriers). Measures to enhance mobility of factors of production include ensuring an adequate social safety net, facilitating re-entry via job placement and retraining services, and instituting legal, fiscal and regulatory frameworks for leasing. Finally, measures to augment resources include foreign investment and management training programmes, and supporting the dissemination of technological and market know-how.

C. The experience of transition economies

Special considerations for transition economies

Patterns of corporate governance of individual enterprises in transition economies are determined primarily by current *ownership structures* together with the prevailing *regulatory and institutional environment*. The distribution of control rights among shareholders and creditors is affected in turn by the methods and particularities of the privatization process and by post-privatization ownership changes, together with the financial structure of the enterprise (which affects the effective role played by creditors). A critical and initially-underemphasized complement to actual ownership structures in determining the effectiveness of corporate governance is the prevailing regulatory and institutional environment, which in turn is affected by existing legal traditions, by recent new rules, and by institutional capabilities and practices (understanding and respect of rules by market participants, capabilities and independence of external auditors and regulators, ability and incentives of institutions charged with enforcement).

A number of features related to corporate governance and restructuring, prevalent in many developing economies, are particularly significant in the transition economies. First, due to a legacy of relative isolation from international best-practice and underdeveloped financial markets, there is a greater *scarcity of expertise and new finance* available to individual enterprises, precisely the two main inputs required for restructuring. Second, the *institutional infrastructure* required for effective restructuring, in terms of product, capital and labour market regulations and enforcement capabilities, together with respect for the rule of law, is much weaker.

²⁰ Although external outside financing may develop without sound protection of investors, as demonstrated in East Asia, such flows are then likely to be much more vulnerable to shaky investor confidence.

²¹ For an overview of barriers to restructuring and associated government policies in the areas of discipline, mobility and resources see Atiyas et al. (1992).

Third, the *magnitude of the problem* in terms of the number of enterprises requiring restructuring and in terms of the mismatch between the prevailing asset mix and market requirements is much larger. This in turn often makes it politically more difficult to effectively harden budget constraints. Fourth, there is a much broader *lack of understanding* within concerned enterprises and civil society at large regarding the requirements and benefits of effective restructuring, in particular with the role of corporate governance in that process.

Ownership, business environment and outcomes

To explore the relationship between corporate governance and restructuring, we first assemble available cross-country evidence on the predominant

ownership structures and the business environment prevailing at the beginning of 1996 in transition economies.²² We then analyse the links between these beginning-of-period policy indicators and subsequent available restructuring outcome indicators at the economy-wide level over 1996 and 1997.

Ownership variables

Table 1 presents all transition economies in three groups according to the primary privatization method—direct sales, mass privatization (MPP) or management-employee buy-out (MEBO). We summarize key determinants of corporate governance across transition economies by grouping countries

according to primary privatization method, given its overwhelming initial influence on the distribution of control rights within enterprises. This grouping is then carried through the remaining tables to clarify the extent to which primary privatization methods are related to other policy choices and restructuring outcomes.

Direct sale refers to ownership transfer of companies as going concerns *to outsiders*, generally in the form of case-by-case cash sale through competitive tender with the company sold to the highest bidder.²³ The transition economies for which direct sale has been the primary method of privatization in terms of transferred asset value through to 1996 are Hungary,

²² 1996 is the first year for which systematic cross-country information on privatisation programs for large and medium-size enterprises across all transition economies is readily available, in the form of Table 5.7 in EBRD 1997, p. 90 and Table 2 in Lieberman et al. (1997), pp. 10-13.

²³ Rather than a controlling block being sold to strategic investors via trade deals through competitive tender or through a private placement, shares can also be placed in the market through a public offering (IPO). This alternate avenue is less attractive for restructuring since the resulting more dispersed ownership structure is unlikely to create sufficient incentives for restructuring.

Table 1. Privatization methods for medium and large enterprises

Country	Direct Sale		Mass Privatization Programme					MEBO
	Trad	IPF comp (*)	Ind/Block	Sold/target firms	IPF Share restr	Concessions to insiders		
Hungary	Primary							Secondary
Estonia	Primary	Yes	No	Individual				
Poland	Primary	No	Yes (15)	Block	6%	33%	Minor	Secondary
Bulgaria	Primary	No	No (92)	Block	27%	34%	Minor	
The Czech Republic	Secondary	No	No (434)	Block	21%	20%	None	
Armenia		Yes	No (2)	Individual	57%	40%		Secondary
Lithuania	Secondary	No	No (180)	Individual		20%	Minor	
Kazakhstan	Secondary	No	Yes (169)	Block	497	31%	Minor	
Kyrgyzstan		Yes	No (17)	Individual	30%	35%	Minor	Secondary
Latvia	Secondary	Yes	Yes	Individual				
Moldova	Secondary	No	No (54)	Block	55%	25%		
Azerbaijan	Secondary		No	Block				
Albania		Yes	No (1)	Individual	12%	10%		Primary
Belarus		Yes	No	Individual				Primary
Croatia			No	Individual				Primary
Georgia	Secondary	Yes	No (9)	Individual		20%	Major	Primary
FYR Macedonia	Secondary							Primary
Romania	Secondary	No	Yes/No (5)	Block		10%		Primary
The Russian Federation	Secondary	Yes	No (650 +)	Individual	58%	25%	Major	Primary
Slovakia		No	No (165)	Block		20%		Primary
Slovenia		No	No	Individual				Primary
Tajikistan								Primary
Turkmenistan	Secondary							Primary
Ukraine		No	No (350+)	Individual	25%	25%		Primary
Uzbekistan	Secondary					35%		Primary

(*) IPF Comp: Investment Privatization Funds Composite.

Estonia, Poland and Bulgaria.²⁴ In both Hungary and Estonia, direct sales were the predominant form of privatization of industrial and infrastructure assets. Between March 1990 and end-1995, the Hungary State Property Agency disposed of roughly 80 per cent of its industrial and service assets, including some 1,700 companies, primarily through direct sales. Almost all industrial assets in strategic sectors such as insurance, banking, telecom, airlines, electricity, gas and oil have been sold to strategic largely foreign investors. Medium-size and smaller companies were sold primarily to domestic investors. Voucher privatization or alternative systems of free distribution were not used to privatize industrial and infrastructure assets.²⁵ Estonia privatized most of its 350 SOEs over 3 years as direct sales to strategic outsiders with heavy reliance on German technical assistance from the *Treuhandanstalt*.²⁶ While Poland from the beginning adopted a multi-track privatization programme and experienced initial political opposition in its emphasis on direct sales,²⁷ the importance of this method nevertheless gradually expanded with larger sales of strategic sector assets: proceeds increased from about \$400 million in 1993 to \$700 million in 1995 and to about \$1 billion in 1996.²⁸ After years of delay, Bulgaria is also privatizing its assets through a variety of methods, including both direct sales and mass privatization. Only about 5 per cent of long-term assets of state-owned enterprises had

been privatized by August 1996, mostly through direct sales.²⁹ Implementation of Bulgaria's MPP began only in 1996. Even during the first wave of mass privatization between 1996 and mid-1997, it appears that preference was given to direct sales wherever possible. For example, the portion of some company assets originally offered in the mass privatization auction was lowered to ensure sufficient shares for management control in concurrent direct sales to strategic foreign investors.³⁰

Mass privatization programmes (MPPs) involve free or heavily-subsidized distribution of shares *to the general public* (outsiders as well as insiders) either directly or via investment funds, generally through vouchers (entitlements to ownership). Such programmes are a systemic approach to privatization. MPPs were designed to overcome specific problems of transition economies by allowing a relatively rapid formal ownership transfer of a large number of companies. This fostered widespread public participation in privatization in situations where potential buyers did not have enough funds to purchase company shares and could not be expected to borrow such funds because of underdeveloped capital markets, where valuation of companies is difficult and wider support of the population is needed. Either through vouchers or promise of subsidies,³¹ MPPs inject sufficient liquidity into the economy for ownership transfer while limiting the inflationary impact by restricting use of the credits from financing consumption directly.

²⁴ Albania is also included while Poland is not in Table 5.7, EBRD 1997. We have altered this classification based on careful consideration of a number of relevant secondary sources (see below).

²⁵ See Annex to Chapter 5, Papp et al.

²⁶ See Nellis (1999).

²⁷ Boycko et al. (1995), based on 1994 evidence, write that "Poland quickly ended the programme (direct sales) once it became evident that the population saw it as a sellout to the Germans". (p.72).

²⁸ World Bank (1999), p.47. In 1998, important additional asset transfers towards the private sector via direct sales occurred in metallurgy, power generation and telecoms. See Rapacki (1999).

²⁹ EBRD (1997), p.158.

³⁰ In July 1996 the share of the Sheraton Hotel offered in the mass privatisation auction was lowered from 25 to 15% following the cash sale of 67% of its shares to Daewoo. Similarly in mid-August 1996 all shares over 50% were lowered because of successful cash privatizations. See Mitrev (1997), p. 185.

³¹ While the Uzbekistan programme is not generally considered to be mass privatisation because it does not include vouchers, we follow Lieberman et al (1997) and include it because it shares many MPP characteristics such as a substantial population-wide available subsidy for purchasers of shares.

The transition economies for which MPP has been the primary method of privatization include Czech Republic, Armenia and Lithuania. These three countries, together with The Russian Federation and Poland, all implemented somewhat different models that were then adopted by other countries. We classify them according to three criteria: the amount of additional concessions granted to insiders; the shares being issued in blocks or individually; the extent of pro-active encouragement to participate in funds; and the incentive structure of the investment funds.

The amount of *additional concessions* granted to insiders has varied substantially across MP programmes, and is one of the factors likely to have the most significant impact on *ex post* corporate governance. At one extreme is the Czech Republic with no official concessions to insiders. Countries adopting

moderate concessions with up-front limited impact on governance prospects by insiders include Kazakhstan (10% of shares given to managers and employees as non-voting stock) and Kyrgyzstan (5% of shares reserved for managers and employees). At the other extreme is Russia. Reportedly, “workers received the most generous concessions of any privatization in the world... Concessions to managers were even larger”.³² Arguably the most important concession to managers was that the MPP did not impose large shareholders (core investors) on firms. On the contrary, the most-frequently chosen MPP option, known as Option 2, directly granted control over privatized firms to insiders: 51 per cent of voting equity was given to managers and workers almost for free.³³ The resulting extent of share ownership that was offered to the public at large via auctions was limited to 29 per cent for most participating companies.³⁴ At the end of the 1992-94 MPP, “managers and workers combined controlled about 2/3 of shares in about two thirds of all privatized firms” (of over 15,000 companies).³⁵ Next to The Russian Federation, the country with the most generous formal concessions to managers and workers was Georgia, where an up-front 36 per cent of share ownership was offered. This could be increased through additional

³² Boycko et.al (1995), p. 93.

³³ At nominal price of 1.7 times July 1992 book value of assets, which in light of the prevailing inflation rate was an extremely low price. In addition, workers could pay for their shares with next-to-free vouchers (all citizens including children received a voucher with 10,000 R denomination for a nominal payment of 25R distributed between October and February 1993) or with the retained earnings of the firm, and could extend payments over some relatively short period of time. Some additional shares could be bought for the pension plan.

³⁴ The so-called strategic enterprises sold less and more was retained in government hands. Boycko et.al (1995), p.84.

³⁵ Nellis, 1999, p.8.

purchases.³⁶ It is because of these unprecedented concessions to insiders that the primary method of privatization for The Russian Federation and Georgia should be classified as MEBO (management-employee buy-outs). For these countries, MPP has been the explicit vehicle for insider privatization by providing government-issued vouchers as liquidity for insider ownership transfer. Although Ukraine’s MPP had no explicit mechanism for managers to elect to purchase majority control over their enterprise on preferential terms in the original design, managers’ preferential access was raised from 5 to 10 per cent of shares in January 1996, so we include that in the MEBO category as well. Based on implementation experience, managers and employees have been reportedly able to maintain control through preferential share purchases.³⁷

A second feature of MPPs that is relevant for *ex post* corporate governance is *whether shares were issued simultaneously for a large block of companies* (typically one or two discrete waves of a large number of enterprises offered at the same time) *or individually* (in more or less continuous fashion, depending on the voluntary timing decision of individual company managers). In Russia, to get the consent of managers and local officials, voucher auctions had to be decentralised and pushed to localities. The authorities could not pull companies in without the consent of managers. However, because auctions were conducted individually and locally, local officials had substantial ability to discourage unwanted investors – and thereby exclude outsiders who may favour the types of radical restructuring that are likely more politically painful in the short-run. In contrast, the

³⁶ In the Georgia June 1995-July 1996 programme, 5% of shares were given to employees for free, an additional 3% were offered at 20 % discount, and an extra 28% earmarked for voucher auctions bought by managers and employees using vouchers.

³⁷ See Drum (1997), p.245.

Czech Republic could pull almost all companies into privatization without the consent of managers, with shares of a large number of companies put on the market simultaneously and sold via centralized price adjustment mechanisms over several rounds. This centralized approach left much less room for external interference from managers to delay auctions of individual companies. It also allowed buyers to compare alternative options directly. The implication for policy is that privatization in blocks appears less vulnerable to special insider deals than individual sales, and therefore in general should be more restructuring-friendly.

A third distinguishing characteristic of MPPs is the *extent to which participation in funds was encouraged*. In the Czech Republic, participation in funds was actively encouraged (also in The Russian Federation, though here vouchers were not registered). In Poland, participation in funds was compulsory (also in Kazakhstan and Romania). In contrast, in Armenia and Lithuania, funds were merely allowed. There is a presumption that countries that use registered vouchers and that at a minimum encourage funds should see the deepest capital market growth, with concomitant pressures on the development of transparent corporate governance mechanisms. The Czech and Polish models have clear advantages in this respect.

Finally, to the extent that investment funds have a sizeable initial holding of company shares following initial privatization, arguably the most important features of MPPs relate to the *incentive structures of the funds* themselves. Perhaps the most important criterion for restructuring incentives is the fund's holding limit in individual companies in terms of share capital. In practice, this has ranged from a low 10 per cent ceiling per company in Albania and Romania, and 20 per cent ceiling in Czech Republic, Georgia, Lithuania and Slovak Republic (later

reduced to 10 per cent), to a high 33 per cent ceiling in Poland. This relates to the intended role of investment funds, that is, whether funds are considered an interim structure to pool otherwise diffuse ownership and facilitate further consolidation or an active restructuring agent.

Almost all countries appear implicitly to have taken the first approach in their policy decisions vis-à-vis investment funds. As an integral part of their MPPs, almost all countries have avoided restructuring prior to privatization (even where substantial liabilities have encumbered the enterprise). The approach has been to decentralize the restructuring process, placing the restructuring responsibility on the new private owners and removing it from the state. However, the incentives built into many investment fund schemes have served to inhibit rather than promote restructuring.³⁸ It is generally agreed that capital markets are too thin for exit via liquidation of fund shareholdings to have a positive impact on enterprise behaviour, so funds cannot play the role of Western mutual funds. On the other hand, by restricting the maximum shareholding in a single company, and by tying fund management company fees to a fixed percentage of the portfolio's net asset value rather than increases in the value of the portfolio, the institutional set-up of most investment funds does not spur restructuring. In practice, severe corporate governance problems in some countries have actually been a disincentive to restructure. Collecting directors' fees, special contracts and non-transparent side-deals, transfer pricing and frequent trading of shares are significantly more lucrative than restructuring. Most worrisome, selling a controlling stake to a strategic investor would remove these benefits.

³⁸ The following is based on Ellerman (1998).

A further problem highlighted in the Czech Republic is the conflict of interest of bank-affiliated funds where banks lend to the same companies that their funds own. At a time when most commercial bank revenue came from interest income, banks lacked strong incentives to behave as active shareholders. Surveys of company managers and board members suggest that large banks used their dual role as creditors and shareholders to extract rents in the form of forced lending, and in some cases forced enterprises to buy from or sell to other companies in the bank's family.³⁹

Of all transition economies, only Poland explicitly chose the second option of administrative design of funds for corporate governance. While the scheme's complexity resulted in political interference and delay (with substantial costs in terms of the deterioration of many companies left in limbo for too long), a longer gestation period also permitted learning from other experiences. This has meant that the stock market is now sufficiently well-developed to enable flotation of shares of portfolio enterprises. In Poland, the number and composition of the funds were not market-determined through bottom-up auctions but rather set top-down by the Government. The National Investment Fund (NIF) programme is a novel type of MPP for in-depth restructuring of companies prior to their formal privatization, with built-in guarantees for effective enforcement of private-like ownership rights and corporate governance by administratively creating a core investor for each company. By July 1995, 512 participating companies had been allocated through an elaborate "football pool" process to 15 NIFs, in total representing about 10 per cent of total industry and construction in terms of sales. The funds, majority-owned by the State Treasury until January 1999, are in turn managed by private consortia of Western and Polish investment banks and business consulting firms (selected by international tender through a detailed pre-qualification and evaluation process closely monitored by EBRD and the World Bank). Of critical importance, 60 per cent of the shares of the participating enterprises were allocated to the NIFs, with a "lead fund" holding a controlling block of shares in 34-35 enterprises plus minority stakes in others. Through civil management contracts, fund managers were given control of enterprise boards. Even more important, the performance fee for fund managers (additional to the fixed fee in cash) is attractive: 1 per cent of the funds' shares each year over 10 years and another 5 per cent at the end.

³⁹ See Desai and Plockova (1997).

Management-employee buy-outs. A third important method of privatization in transition economies has been the sale or give-away of all or substantial ownership of companies to *insiders*, to their existing managers and employees, known as MEBOs. Albania, Belarus, Croatia, Georgia, Macedonia, Romania, Russia, Slovenia, Slovak Republic, Tajikistan, Turkmenistan, Ukraine and Uzbekistan all appear to have relied on MEBOs as the primary privatization method in terms of assets transferred through 1996.⁴⁰ The Russian Federation and Georgia are included in this category due to the sizeable concessions to managers and employees granted through the MPP process, and the consequent small percentage of shares available to outsiders. A number of the other countries had explicit alternate track privatization methods where viable state-owned enterprises were declared liquidated and then registered as a whole or sold piece-meal to existing managers and employees.

In addition to the extent of insider concessions, two other criteria affected whether a country with MPP was classified as primarily MEBO. First, the estimated percentage of shares of all companies acquired by investment funds during voucher distributions gives an indication of the percentage of remaining shares that could have been acquired by insiders. In Romania, private ownership funds could only participate after the completion of the subscriptions by individuals, with only 14.5 per cent of vouchers in the end entrusted to investment funds. This, together with attractive payment facilities for 40 per cent of shares that could not be exchanged for vouchers but had to be paid for in cash, led to associations of employees and managers purchasing a majority of the shares.⁴¹

⁴⁰ Albania, Georgia and The Russian Federation are the only countries in this list that are classified elsewhere in Table 5.7, EBRD (1997). See below for our rationale.

⁴¹ See Tardy (1997), pp.225-8.

Second, the number of companies sold via MPP relative to the official number of medium-size and large state enterprises targeted for commercialization gives an indication of the size of the programme relative to other methods. To the extent that direct sale was not predominant, the likelihood of ownership transfers via MEBOs increases. In Albania, of 833 medium-size and large state enterprises targeted for commercialization, the privatization commission selected less than half (about 350) for transformation, with the balance supposedly earmarked for liquidation with assets transferred to managers and owners. Of the 350, a handful of the largest enterprises generally involving infrastructure or natural resources were considered most in need and most attractive for investment by a strategic foreign investor and assigned for direct sales. Only 97 enterprises (or 12% of medium-size and large SOEs) have been sold through MPP in five rounds from October 1995 through July 1996. In addition, special benefits were given to employees, allowing them to bid all their vouchers at the beginning (those received in a first tranche as well as those they would receive in future tranches) for shares of their own companies, reportedly leading to greater employee share ownership than otherwise.⁴²

The Slovak Republic is another example where MPP accounted for substantially fewer enterprises than originally planned. While Sk 80 billion of assets (in terms of book value) were transferred in 1992 as part of Czechoslovakia's first wave of MPP voucher privatization to individual investors and investment funds, a new government after independence abandoned mass privatization in favour of direct sales and tenders. During this second Slovak wave, in contrast to the traditional targeting of direct sales to outsiders, insiders were strongly preferred for acquiring controlling equity at favourable financial terms. Managers and

employees were required to make a down payment of just 20-30 per cent of the sales price, with the rest to be paid in instalments. In many instances, the sales price was less than the book value of the enterprise. By early 1995, procedures for selecting enterprises and for agreeing on financing are reported to have become even more politicized and less transparent. Of the Sk 226 billion assets of completed privatizations by end-1996, 65 per cent had gone largely to managers and employees.⁴³

Business environment variables

Relevant regulatory and institutional features of the business environment are presented in Table 2. Business environment indicators that reflect the effectiveness of internal mechanisms of governance include whether minority shareholder rights are protected (ranging between ineffective and partly effective)⁴⁴, whether insider dealing is prohibited by law (no or yes), and whether a securities and exchange commission exists separately from any ministry (no or yes). Indicators that reflect the effectiveness of external mechanisms of governance include whether court proceedings are effective in encouraging creditors to use judicial settlement and liquidation proceedings (ranging from ineffective to effective). An overall "progress in transition" EBRD policy rating on the legal environment for enterprise governance and restructuring ranks countries on a 1 to 4+ scale ranging from few if any reforms to promote corporate governance (1), to effective corporate control standards exercised through domestic financial institutions and markets typical of advanced industrial

⁴² See Artemiev and Fine (1997), pp. 178-80.

⁴³ See Dado (1997), pp. 236-40, who claims that "the popular perception that most direct sales during 1995-6 favoured mainly enterprise managers and employees has undermined privatisation.

⁴⁴ The effectiveness of legal protections of shareholder rights is based on a country-by-country survey of domestic and foreign lawyers and legal experts. Although options ranged from ineffective to effective, no country was ranked as effective. This and following measures are based on EBRD (1998).

economies fostering market-driven restructuring (4+).

In addition to indicators directly affecting the effectiveness of corporate governance mechanisms, three other business environment indicators are included that reflect the importance of complementary policies that facilitate restructuring. First, a 2-year series reflects the recent trend in budgetary subsidies to enterprises as a percentage of GDP as an indicator of the magnitude and changes over time in the tightness of budget constraints facing the enterprise sector as a whole. However, the fact that implicit subsidies can come through direct credits from commercial banks, credits at preferential rates and import subsidies suggests that this indicator underestimates the extent of soft budget constraints.⁴⁵ Second, a trade and foreign exchange system indicator on a 1 to 4+ scale reflects the extent to which import and export restrictions and tariff barriers are removed. Third, a competition policy indicator ranks countries on a 1 to 4+ scale depending on the policy effectiveness of competition policy legislation and enforcement institutions. These last two variables

should reflect the extent to which foreign and domestic competition may compensate for any weaknesses in internal governance.

On the surface, there appears to be a fairly strong positive correlation between countries that have opted for direct sales as their primary privatization method (and thereby have enterprise control structures with more strategic outside investors) and countries that have made legal and institutional choices favouring

effective governance. In countries where strategic outside investors have been favoured (the direct sales group), all four countries score relatively favourably on internal and external governance rules (except for Bulgaria with respect to bankruptcy procedures); and two out of the four score very favourably in terms of foreign competition pressure. In contrast, in countries where insiders have been favoured (the MEBO group), only four out of 13 countries score relatively favourably on all three internal governance rules, none on the external bankruptcy criterion, and only one country (Slovenia) scores most favourably in terms of foreign competition pressure. Interestingly, not all countries that score very favourably with respect to the business environment have chosen to rely predominantly on direct sales, with The Czech Republic and Slovenia being the most notable exceptions.

⁴⁵ Moreover, recent evidence of a proliferation of barter and non-monetary transacting in Russia, as well as quasi-fiscal transfers through utilities and other publicly-controlled institutions suggests that this officially-recorded indicator probably fails to capture the extent of continuing soft budget constraints. (See Commander and Mummsen (1999)).

Table 2. Business environment indicators

	Cg	Int	Ext			Complementary policy			Budgetary	
			Protec	Ins	Sec	Bankr	Comp	Comp	Trade	Subsidies
		Shar.	Deal	Co	Proc.	Office	Policy	and X		
			Proh	m				system		
	96	P/N	Y/N	Y/	Y/P/N	96	96	96	96	97
	Ratin		N	N		Ratin	Ratin	Rating		
	g					g	g			
Hungary	3	Partly	Yes	Yes	Yes	Yes	3	4+	3.9	3.3
Poland	3	Partly	Yes	Yes	Yes	Yes	3	4+	2.5	
Estonia	3	Partly	Yes	Yes	Yes	No	3-	4	0.4	0.3
Bulgaria	2+	Partly	Yes	Yes	Partly	Yes	2	4	0.8	0.8
The Czech Rep	3	Partly	Yes	Yes	Partly	Yes	3	4+	2.2	2.4
Lithuania	3-	Partly	Yes	Yes	Partly	Yes	2+	4	1.3	0.9
Armenia	2	Partly		Yes	Partly	No	2	4	0.1	0.4
Kazakhstan	2	No	No	Yes	No	Yes	2	4		
Kyrgyzstan	2	Partly	Yes	Yes	Partly	No	2	4	4.7	3.7
Latvia	3-	Partly	Yes	Yes	Partly	Yes	3-	4	0.3	0.4
Moldova	2	Partly	Yes	Yes	Partly	No	2	4		
Azerbaijan	2	No	Yes	No	No	No	1	2+	2.1	0.7
Albania	2	No	Yes	Yes	No	No	2	4	0.4	0.5
Belarus	1	No		No	No	No	2	1	2.9	1.3
Croatia	3-	Partly	Yes	Yes	Partly	Yes	2	4	1.9	1.9
Georgia	2	No	No	No	Partly	Yes	2	4	1	1.5
Macedonia	2	Partly		Yes	Partly	No	1	4	2	0.3
Romania	2	Partly	Yes	Yes	Partly	Yes	2	4	4.3	2.6
The Russian Fed	2	Partly	Yes	yes	No	Yes	2+	4	6.2	6.4
Slovakia	3-	No	Yes	No	No	Yes	3	4	2.4	
Slovenia	3-	Partly	Yes	Yes	Partly	Yes	2	4+	1.2	1.3
Tajikistan	2-	No	Yes	No	No	No	1	2	0.7	1.1
Turkmenistan	2-	No	No	No	No	No	1	1	0.8	0.7
Ukraine	2	No		Yes	No	Yes	2	3		
Uzbekistan	2	No	Yes	Yes	No	Yes	2	2-	4	3.2

From ownership structures to restructuring outcomes

Table 3 presents available data on enterprise ownership structures and restructuring outcomes, again

grouped according to primary privatization method. Restructuring-related outcome variables include changes in labour productivity in industry, non-natural resource exports to GDP (as an indicator of success of enterprises in restructuring their product

Table 3. Restructuring-related indicators

	Pvt share GDP	FDI (per capita) US\$ million		Labour Prod in Industry (% change)		Export/ GDP	
		96	96	97	96	97	96
Hungary	70	197	207	9	15	0.339	0.468
Poland	60	73	79	10	14	0.193	0.215
Estonia	70	76	88	4	18	0.428	0.543
Bulgaria	45	12	60	2	-4	1.310	1.266
The Czech Rep	75	136	124	10	11	0.386	0.400
Lithuania	65	41	59	9	5	0.432	0.531
Armenia	50	6	14	20	-2	0.191	0.153
Kazakhstan	40	70	84	12	17	0.327	0.352
Kyrgyzstan	50	10	18			0.268	0.319
Latvia	60	150	139	9	28	0.292	0.361
Moldova	40	13	15	16		0.426	0.438
Azerbaijan	25	88	144	16	10	0.236	0.242
Albania	75	30	13			0.084	0.061
Belarus	15	7	19	11	20	0.487	0.621
Croatia	50	113	41	11	12	0.234	0.217
Georgia	50	10	35			0.092	0.102
Macedonia	50	6	14	-9	15	0.301	0.316
Romania	60	12	54	12	1	0.297	0.310
The Russian Fed	60	12	25	3	3	0.228	0.224
Slovakia	70	37	9	3	5	0.489	0.486
Slovenia	45	93	161	7	5	0.463	0.465
Tajikistan	20	3	2			0.818	0.793
Turkmenistan	25	28	23	10	-30	1.123	0.504
Ukraine	40	10	12	2	6	0.347	0.345
Uzbekistan	40	4	7	4	6	0.346	0.362

mix in line with international competitiveness requirements), and non-natural resource FDI per capita (as an indicator of market-oriented investment

opportunities that should be greatest in enterprises embarked on restructuring and subsequent expansion).⁴⁶ Of these three measures, labour productivity changes are probably the most appropriate direct measure of restructuring-related outcomes over the short term, especially since export adjustment requires additional time to break into new markets and is more sensitive to exchange rate trends while foreign investment flows may exhibit greater sensitivity to other factors including the magnitude of externally-financed privatization transactions. By adopting the strict criterion that restructuring outcomes should be reflected in improvements in all three sets of indicators, and further restricting attention to those countries for which the privatization share in GDP was greater than 50 per cent in 1996 (to ensure that privatization outcomes are actually reflected in the behaviour of a significant share of the economy's enterprises), the only countries that rank well are Hungary, Poland and Estonia. The economies that adopted mass privatization programmes show mixed evidence in terms of restructuring outcomes, depending on the particular characteristics of the programme: in particular, the amount of additional concessions granted, the extent of encouragement to participate in funds, and the incentive structure of the funds themselves as described above. The Polish scheme's complexity resulted in delay, but allowed the stock market to be sufficiently well-developed to enable flotation of shares of portfolio enterprises. It also permitted learning from earlier experiments. The National Investment Fund programme is a novel type of MPP for in-depth restructuring of companies prior to their formal

privatization. Built-in guarantees for corporate governance were instituted top-down by the Government rather than through the market by administratively creating a core investor for each company. The public has displayed strong interest in vouchers and with the way most fund managers have been handling their portfolios. Among the most important outcomes during the period 1995 to 1998 were: new private owners (mostly strategic investors) were found for 253 companies, including 52 listed on the stock exchange; new products were introduced in 455 companies; 461 companies embarked on new technologies and/or upgraded existing equipment; new investment amounted to 1.8 billion zlotys (US\$ 500 million); the ratio of companies generating profits increased from 40 per cent in 1995 to 64 per cent in 1998; bankruptcy or liquidation occurred in 34 companies. The other countries have performed less well so far on all restructuring outcome indicators.

D. Policy lessons: recommendations for ongoing and future privatizations

The links between privatization method adopted, business environment policy choices taken, and restructuring outcomes achieved to-date, although only suggestive, support a number of policy-relevant messages. The usefulness of these messages is reinforced by the country-specific experiences outlined above. In particular, the evidence presented supports the following four broad conclusions:

- (1) The combination of direct sales to strategic outsiders and transparent corporate governance rules, where feasible, represents the recommended privatization method to promote desirable restructuring decisions.

From the perspective of profit-oriented restructuring, direct sales to strategic outsiders should be the preferred form of

⁴⁶ The export and FDI statistics reported in Table 3 do not exclude natural resources.

privatization. Informed external investors with a strategic share have comparatively stronger incentives and ability to identify and bring in appropriate restructuring agents with industry-specific knowledge and necessary finance. In addition, foreign outsiders bring new techniques of production and help implant new standards of corporate governance. The bias in favour of direct sales to strategic outsiders should be particularly relevant in transition economy environments lacking well-enforced protection of minority shareholders since, in such settings, new external owners should have less incentive to loot. External investors (whether a family with other interests, a domestic group or a foreign company) have implicit incentives for appropriate conduct from their concern with their reputation, based on the possible loss of country-wide or international profits from sales on other products arising from perceived misconduct in a particular enterprise. In addition, new external owners lack the same established insider network connections with the existing management team, workers, local politicians and other enterprises that may have facilitated effective looting by previous managers/owners.

The main fears about direct sales in terms of delay, shortage of domestic capital and doubtful political feasibility

appear less severe in light of the recent experience reported above. First, direct sales are not necessarily too slow. Hungary and Estonia provide early cases of relatively quick restructuring-friendly ownership changes. On the contrary, there appears in retrospect to have been an initial over-emphasis on speed at the expense of structuring appropriate post-privatization restructuring incentives. Second, the availability of limited private domestic savings should not be seen as a prohibitive constraint. While it was initially feared that the amount of private domestic savings in any country may be minuscule in comparison to the estimated value of saleable assets, the Hungarian evidence suggests that large strategic companies will be attractive to foreigners provided that sufficient control rights are offered and the restructuring environment is appropriate.

The political feasibility of direct sales can be enhanced through careful sequencing, coupling public education with appropriate use of secondary methods of privatization. An education process emphasizing the requirements and expected benefits of appropriate restructuring, contrasted with probable continued stagnation from insufficient or inappropriate restructuring, is of critical importance where the local population has limited experience with market capitalism (combined often with intentionally-distorted prior information). The claim that “privatization through sales offers no tangible benefit to the public at large” must be vigorously countered with as many concrete examples of successful restructuring and eventual growth in employment and incomes following direct sales, versus unsuccessful restructuring under alternate methods. A complementary tactic adopted by Poland is to slow down direct sales if opposition becomes too intense and introduce alternate secondary methods including mass privatization and employee buyouts, coupled with a general policy stance facilitating as much new entry as possible. Direct sales can then slowly be built up again, especially to attract the necessary financial resources and expertise required for restructuring in strategic industrial and infrastructure sectors.

In the absence of sufficient legal protection for minority investors, new owners may find it more profitable to divert assets than to restructure. Protection of minority investors is also critical to ensure that the privatization process be perceived as socially legitimate. Otherwise, it becomes difficult to attract outsiders, as well as to sustain restructuring and avoid backtracking. There is a need to impose a small number of mandatory internal mechanisms of governance in transition economies, including simple and transparent rules to be followed by all publicly-held enterprises backed up by credible enforcement institutions. It is then desirable to publicize such rules widely, facilitate the reporting of transgressors and ensure swift adjudication, with clearly stipulated sanctions for companies that fail to comply. These rules may include: an obligation for enterprises to disclose financial statements—ideally on the Internet, a requirement of prior shareholder approval of the purchase or disposal of substantial assets, and a clear duty for directors to act in the best interest of the company by clearly spelling out the illegality of self-dealing. The use of simple rules, by increasing transparency and reducing the scope for discretion on their interpretation, may dramatically facilitate their implementation.

- (2) Given that post-privatization ownership changes that enhance restructuring are more difficult once entrenched interests have gained legitimacy through private ownership, the initial privatization design and prevailing corporate

control environment should be structured to facilitate changes in enterprise ownership and control.

Early privatization decisions that have not led to restructuring have in practice been hard to unravel, and post-privatization asset reorganizations have generally turned out to be much more difficult than initially envisioned. Political constraints may require substantial insider ownership with control exercised by existing managers and employees, or direct sales to outsiders who subsequently do not take required restructuring decisions. However, such initial privatization will not be as harmful as long as ownership can be readily transferred and that the incentives exist to do so. The key policy message here is that the initial privatization design should prevent the individual and collective blocking of resale of control rights to other external financiers who may profitably be able to restructure an enterprise. In addition, enterprise decision-makers need to face sufficient market discipline (in the form of hard budget constraints and competition) either to attempt to mobilize the necessary resources to undertake growth-oriented restructuring on their own or to transfer control to the best-placed market participant to do so.

A number of practical recommendations have emerged based on transition economy experiences to date in this area. Employees should own shares as individuals rather than as collectives and be free to sell their shares whenever they want. When setting up the rules for investment funds, policy-makers should avoid closed-end funds and incentive schemes for fund managers that reward inaction more highly than selling a controlling stake to a strategic investor.

- (3) Key elements of the business environment to support desirable restructuring—including rules and institutions to ensure the feasibility of hard budget constraints and to promote maximum competition—should be in place prior to or concurrent with privatization.

Especially in environments where small, dispersed investors are unlikely to play an important role promoting the necessary corporate restructuring, additional measures are essential to strengthen discipline and prevent enterprises being shielded from adjustment pressures. The most important of these additional measures are undoubtedly those that promote competition, including elimination of soft budget constraints (initially by converting indirect and non-transparent supports such as through barter, loan roll-overs, tax arrears and non-payment to utilities into explicit, on-budget declining subsidies) and strengthening of product market competition (by eliminating other anti-competitive government and private sector practices with a special focus on reducing entry barriers).

4. A continuous public education campaign should be undertaken to educate concerned enterprises and the population at large about the requirements and benefits of restructuring, and the role of effective corporate governance in that process.

In the area of corporate governance as with other regulations, there is a need to build demand for effective regulation. Demand for regulation, in turn, is dependent on both better information (a clear understanding by the public of the purpose and benefits of regulation, and the costs of absent or inappropriate regulation) and mobilization efforts. Given the lack of experience of the public in transition economies with the rationale and effective forms of corporate governance in well-functioning markets, and the magnitude of the restructuring challenge facing these countries, education in this area is perhaps even more critical than in most other regulatory areas. Education efforts should initially be targeted to those groups likely to benefit most from privatization and restructuring, in order to ensure sufficient support from these parties.

Stock Market Growth and Privatization in Developing Countries

2

References

- Atiyas, Izak, Mark Dutz and Claudio Frischtak (1992) *Fundamental Issues and Policy Approaches in Industrial Restructuring*, IEN Working Paper No. 56 (Private Sector Development Department), The World Bank, Washington DC.
- Baumol, William (1959) *Business Behavior, Value and Growth*, Macmillan, New York.
- Berle, Adolf and Gardiner Means (1932) *The Modern Corporation and Private Property*, Macmillan, New York.
- Berglof, Erik and Ernst-Ludwig von Thadden (1999) The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries, mimeo.
- Boycko, Maxim, A. Shleifer and R. Vishny (1995) *Privatizing Russia*, Cambridge, Massachusetts. Massachusetts Institute of Technology Press.
- Carlin, Wendy (1998) Privatization, enterprise restructuring and corporate governance in transition; an update on empirical studies, University College, London, mimeo.
- Coase, Ronald (1937) The nature of the firm, *Economica* 4, 386-405.
- Dinc I. S.(1998) The Shareholding Structure of Japanese Banks and Their Real Estate Lending in the 1980s, Tokyo University, mimeo
- Ellerman, David (1998) Voucher privatization with investment funds: An institutional analysis', *World Bank Policy Research Working Paper No. 1924*, The World Bank, Washington, DC.
- Estrin, Saul and John Earle (1998) Privatization, Competition and Budget Constraints: Disciplining Enterprises in Russia, SITE and London Business School, mimeo.
- Estrin, Saul and Adam Rosevear (1998) Enterprise Performance and Corporate Governance in Ukraine, London Business School, mimeo.
- European Bank for Reconstruction and Development (1995-1998) *Transition Report*, London.

- Frydman, Roman, Marek Hessel, Andrej Rapaczynski (1998) Why Ownership Matters ? Politicization and Entrepreneurship in the Restructuring of Enterprises in Central Europe, New York University, mimeo.
- Grosfeld, Irena and Jean-Francois Nivet (1997) Firms' Heterogeneity in Transition: Evidence from a Polish Panel Dataset, Davidson Institute, Ann Arbor, Michigan, Working Paper 47, May.
- Shleifer, A and R. Vishny (1997) A Survey of Corporate Governance *Journal of Finance*, 52 (2).
- Weiss A. and Nikitin G. (1998) Performance of Czech Companies by Ownership Structure Boston University, mimeo.
- World Bank (1999), *Czech Republic: Capital Market Review*, Washington, D.C., February.
- Jensen, Michael (1986) Agency Costs of Free Cash Flow, Corporate Finance and Takeovers, *American Economic Review*, 76, 2, 323-29.
- La Porta, R and Lopez-de-Silanes, F. (1997) Legal Determinants of External Finance, *Journal of Finance*, 52 (3).
- Lieberman et al (1997) *Between State and Market*, World Bank, Washington DC.
- Marris, Robin (1964) *The Economic Theory of Managerial Capitalism*, Free Press of Glencoe, Illinois.
- Meggison, William and Jeff Netter (1998) *From State to Market: A Survey of Empirical Studies on Privatization*, Paris, mimeo.
- Mirrlees, James (1976) The optimal structure of incentives and authority within an organization, *Bell Journal of Economics* 7, 105-131.
- Nellis, John (1999) *Time to Rethink Privatization??*, World Bank, Washington DC, mimeo.
- Pohl, G. Anderson, R. S. Claessens and S. Djankov (1997) *Privatization and Restructuring in Central and Eastern Europe*, Technical Paper, The World Bank, Washington DC.
- Rapacki, Ryszard (1999) *Privatization in Poland: Major Issues, Trends and Policy Concerns'*, (Chapter XVI of this book), United Nations DESA, New York.

IV. STOCK MARKET GROWTH AND PRIVATIZATION IN DEVELOPING COUNTRIES

A. Expansion of stock markets and its sources

During the past decade there has been a dramatic expansion in the stock market capitalization of both developing countries and industrial countries. Between 1988 and 1997, the stock market capitalization of the industrial countries expanded from \$9.7 trillion to \$24 trillion while the stock market capitalization of the developing countries grew from \$500 billion to nearly \$2.3 trillion.

The expansion of stock market capitalization in the industrial countries resulted from a mixture of cyclical and structural factors. The U.S. economy enjoyed a benign period of steady growth with low inflation which boosted both corporate profits and stock market multiples. European markets benefited from the impact of monetary union on interest rates as well as an upsurge of privatizations in sectors such as telecommunications.

The developing countries benefited from some of the same business cycle factors which encouraged benign stock market performance in the industrial countries but their performance was far more dependent upon tremendous structural changes resulting from the end of the cold war and the spread of liberal economic ideas to hitherto mercantilist or Marxist economic

systems. Indeed, in the aftermath of the cold war, the developing countries were rechristened as the so-called “emerging market economies” because of investor perceptions that they represented a far more exciting growth opportunity than the old industrial countries.

There were several factors which drove the expansion of stock market capitalization in the developing countries during the 1990s.

First, in the aftermath of the cold war, there was a dramatic expansion of capital flows to developing countries. They rose from about \$40-50 billion per annum in the late 1980s to a peak of nearly \$300 billion in 1996. These capital flows included direct investment and bank lending, not just purchases of equity and debt securities, but capital markets served

as an important conduit for money flows to developing countries for the first time since the heyday of global capital mobility in the half century before the First World War. It is estimated that portfolio capital flows to equity markets rose from \$3.5 billion in 1989 to \$45.8 billion in 1996.

Secondly, there was a tremendous expansion in the number of developing countries with stock markets after the end of the cold war. Before 1989, the largest developing country equity markets had been in East Asia, South Africa and a few Latin American countries. During the 1990s, stock markets have appeared in eastern Europe, the former Soviet Union and China while the markets which existed before 1989 have experienced dramatic growth. In 1998, for example, six countries (Brazil, India, Korea, Malaysia, South Africa, Taiwan) accounted for 83 per cent of all emerging market capitalization, whereas in 1997 they accounted for just 46 per cent of the total.

Thirdly, many developing countries promoted development of their equity markets by privatizing State-owned companies. In Mexico, for example, the privatization of both Telmex and the banks significantly boosted both stock market capitalization and foreign investment in the market during the early 1990s. In 1993, Telmex, alone, accounted for a third of the country's total market capitalization. Chile, Brazil and Argentina also gave a significant boost to their stock market development by privatizing telephone companies and utilities as well as selective State-owned commercial and resource companies, such as Yacimientos Petroliferos Fiscales (the great Argentine oil company). In Asia, governments have privatized telephones and utilities as well as a variety of infrastructure projects. There are now publicly listed toll road companies in Thailand, Malaysia, China and Indonesia. The Asian markets also have several port companies, including a Filipino firm which has itself been

privatizing ports all over the world. Governments in eastern Europe and the former Soviet Union have also made extensive use of stock markets to promote privatization. The Czech Republic, Poland and Hungary privatized their banks soon after the end of communism and used the equity market to help recapitalize them. Hungary and

the Czech Republic also moved quickly to privatize their utilities and telephone companies while Poland is now catching up. Russia also had a privatization boom during the mid-1990s which led to equity market trading in several of its State-owned oil companies, telephone companies and utility companies as well as a wide variety of industrial enterprises. Before the August 1998 financial crisis, foreign investors had been very enthusiastic buyers of Russian telephone, utility and oil companies on the grounds that they sold at large valuation discounts to comparable companies in both the industrial and developing countries. Indeed, it would not be an exaggeration to say that telephone companies are now playing a role in global portfolio investment decision making comparable to that played by railway companies during the late 19th century. In the 1880s and 1890s, it was commonplace for British investment trusts to have 20-25 per cent of their funds in North American and Latin American infrastructure companies, especially railroads. The communications sector accounts for 11.0 per cent of all emerging stock market capitalization today compared to 15 per cent for banking, 8.8 per cent for mining and 35 per cent for manufacturing. The transportation, communication, and utility sectors account for over 40 per cent of stock market capitalization in Brazil, Chile, Peru, Venezuela and Hungary.

Fourthly, there was a tremendous upsurge of equity issuance by all companies, not just government owned enterprises, as stock market capitalization grew during the 1990s. It is estimated that domestic capital market issuance in the emerging markets of the Asian tigers rose from 0.5 per cent of GDP during the period 1980-1985 to 2.3 per cent during the late 1980s and 2.2 per cent during the early 1990s. In twenty three other emerging market, it rose from 0.3 per cent of GDP in the first half of the 1980s to 0.9 per cent in the period 1990-95. There was an equally sharp upsurge in the magnitude of bond financing in developing countries during the same period. In the Asian tigers, for example, it rose to 4.7 per cent of GDP during 1991-1995 from 1.9 per cent during 1980-1985.

Finally, many developing countries have been introducing pension funds in order to encourage retirement savings. The rise of pension funds is helping to institutionalize a flow of savings into stock and bond markets which is unprecedented in the history of the developing countries. Singapore and Malaysia created a compulsory retirement savings programme shortly after independence in order to help finance economic development. Chile took the additional step in 1980 of creating universal retirement savings accounts which gave individuals a choice over where to allocate their savings. Instead of having a Singapore-style central provident fund monopolizing retirement savings, Chileans were given a choice of thirty different fund management companies as outlets for their retirement savings. The Chilean programme was so successful in boosting savings that it has now been imitated by Argentina, Mexico, Bolivia and Peru. Hungary and Poland have also just introduced universal retirement savings programmes which borrow heavily from the Chilean model. In the old industrial countries, there has been a strong correlation

between the growth of pension funds and the size of stock market capitalizations. The United States., Britain, Australia and other English speaking countries have large stock market capitalizations (80-140 per cent of GDP) in part because their pension fund assets are now equal to 60-80 per cent of GDP. Germany, France and Italy, by contrast, have small stock markets capitalizations (20-40 per cent of GDP) because they have lagged far behind in creating tax deferred retirement savings programmes.

B. The financial crisis of 1997-1998 and the future of the emerging markets

The capitalization of the emerging market countries grew steadily between 1988 and 1996. It fell slightly during 1997 as a result of the Asia crisis and briefly plunged to a level of \$1.6 trillion during September 1998 as a result of Russia's default and a flight to quality which rocked all financial markets. The emerging markets had also suffered a modest correction during early 1995 when Mexico stunned investors by abandoning its exchange rate peg for the peso and floating the currency. In the weeks which followed there was an outflow of capital so large that Mexico's foreign exchange were exhausted and the country would have defaulted on its dollar linked government securities if the U.S. Treasury and the IMF had not provided an emergency loan of \$40 billion (the largest international aid programme since the Marshall Plan in 1948). But because Mexico's rescue programme stabilized her markets after a few months and permitted an economic recovery during 1996, it did not have as crippling an impact on markets as the Asian financial shocks of 1997-98.

The crisis in Asia and The Russian Federation had a more devastating impact than the Mexican devaluation for several reasons.

First, the Asia crisis came after a decade of such outstanding economic performance that it took most investors and bankers by surprise. Mexico also surprised equity investors in 1994 but it did not stun bankers because there had been as default as recently as 1982.

Secondly, the Asia crisis had been the by-product of different capital account vulnerabilities than Mexico's and thus was more difficult to contain. Mexico experienced a crisis in 1994-1995 because she had been financing a large current account deficit (7-8 per cent of GDP) primarily through the sale of equities and bonds to foreign investors, especially in the United States. While foreign direct investment was also increasing, Mexico was far more dependent upon securitized capital flows than any other developing countries during this period. As a result, it was vulnerable to sudden suspensions of capital flows when rising the United States interest rates, two political assassinations, and the large current account deficit suddenly frightened foreign investors. In Asia, by contrast, the capital account vulnerability was the tremendous expansion of foreign currency bank lending which had occurred during the 1990s as a result of Asia's history of stable exchange rates and the appetite of European and Japanese banks for expanding their loan portfolios in the region. As most Asian countries had exchange rate links to the United States dollar, their corporate sectors decided to take advantage of interest rate differentials by borrowing heavily in dollars. While such borrowing made sense on a company by company basis, it created the preconditions for a crisis when Thailand's devaluation in July 1997 called into question corporate assumptions about exchange rate stability in the whole region. As companies rushed to hedge their dollar liabilities, they produced a cascade effect in the markets which overwhelmed all other capital flows and caused their national currencies to fall more sharply than could be justified on the basis of inflation differentials or budget deficits. The interaction between collapsing currencies and large dollar liabilities produced a wave of bankruptcies in both financial institutions

and public companies which will require at least two or three years to resolve. In the case of Indonesia, it also unleashed a wave of mob violence and ethnic hostility so severe that business confidence has been crippled and GDP contracted by over 15 per cent during 1998.

Thirdly, the IMF and the United States Treasury were unable to prevent the Russian Federation from defaulting on her domestic currency debt despite widespread perceptions that the Russian Federation "was too nuclear to go bust". The Russian default then triggered a capital flight by investors from all emerging market countries, causing equity prices to fall sharply and interest rates to sky-rocket. Investor confidence improved when the United States Congress finally approved the long delayed capital expansion for the IMF and a relief programme was announced for Brazil but the failure to save The Russian Federation punctured the moral hazard illusion that some countries were too important to go bust.

Finally, the world had enjoyed such benign financial market conditions during the period 1995-1998 that there was a tremendous expansion of bank lending to highly leveraged investors such as hedge funds. This upsurge of borrowing for speculative investing reinforced the shock effects of the Russian default by forcing many of the highly leveraged investors to unwind their positions. There is no easy way to measure the role of leverage in any stock market correction but the fact that Brazil's devaluation generated less financial contagion than the Russian Federation was in part a by-product of the fact that there had been a significant reduction of hedge fund leverage during the autumn of 1998.

The performance of emerging markets has been so poor during the past two years compared to North America and Europe that many pundits are now very pessimistic about their recovery prospects. There is little doubt that both institutional and retail demand for emerging market securities is

likely to be subdued during the short-term because of investors reallocating portfolios in favor of markets which have performed well. But it is also possible to construct a positive scenario for emerging markets because of the institutional reforms which many developing countries are now pursuing in response to the crisis.

The reform policies now occurring reflect the experience of each country. Some perceive that their problems have resulted primarily from volatility in global capital flows and thus they want to restrict freedom of access for hot money. Others are focusing on defects in their microeconomic policies and systems of financial supervision which are now perceived to have created the pre-conditions for trouble even before Thailand's devaluation.

Three microeconomic hazards stand out in the Asian experience. First, many countries did not have effective systems of bank supervision to regulate how their local institutions utilized the large amounts of foreign capital which suddenly became available to them after 1990. Ratios of debt to GDP rose sharply in countries, such as Thailand, Malaysia and Indonesia, but the system of financial intermediation failed to keep up with the dramatic changes occurring in the country's access to foreign capital. In some countries, governments also magnified the problem by restricting the ability of global banks to lend directly to local companies and forcing them to rely on local intermediaries as their channel for obtaining access to the marketplace.

Secondly, many Asian companies significantly over-leveraged themselves with short maturity dollar debt because their countries had for many years been successfully maintaining exchange rate links to the United States dollar. During the 1980s, the link to the United States dollar had provided these Asian countries with a

useful anchor for stable monetary policy as well as a commercially competitive exchange rate. But in the aftermath of the cold war and the tremendous surge of capital flows to emerging markets, it had the unintended side effect of encouraging dollar over-leveraging. As a result, once Thailand devalued last summer, there was a cascade of selling pressure against all Asian currencies as local borrowers rushed to hedge, banks slashed credit lines, and portfolio investors stepped aside.

Thirdly, the capital allocation process in many Asian countries suffered from a mixture of political favoritism and a general corporate insensitivity to profitability despite the fact that the government share of GDP was small. These factors created the preconditions for debt servicing problems when the financial environment turned adverse for new borrowing. The most extreme example of this problem was Korea. During the modern era, Korea has become an industrial powerhouse in steel, semi-conductors, ship-building, petrochemicals, and autos through aggressive corporate investment financed overwhelmingly by bank lending. But in embarking upon these ambitious investments, the Korean corporate sector usually focused far more attention on criteria such as sales and market share rather than profitability and return on capital. As a result, debt servicing ratios rose to levels which threatened many companies with bankruptcy when their surplus industrial capacity depressed export prices and foreign bankers suddenly became reluctant to extend new loans. In the 1970s and 1980s, Korea's high leverage investment policies had not created great financial risks because most of the borrowing had been financed by local banks and in local currency under the auspices of the government's industrial policy. But in the 1990s, Korea's decision to join the OECD and liberalize its financial system opened the door to heavy borrowing

from the global financial system. The foreign banks made loans primarily in dollars and did not belong to corporate stakeholder groups comparable to the ones which had helped to finance the early stages of Korea's industrialization drive. Ironically, Korea's decision to join the OECD also produced an automatic upgrade in its credit status which caused many international banks to overlook the great differences between the Korean and western forms of capitalism. Western bankers incorrectly perceived Korean enterprises to be profit-maximizing companies, not privately owned agents of government industrial policy with targets for output rather than cash flow.

In southeast Asia, the major problem with corporate investment decision making was not so much industrial policy as old fashioned political favoritism. In Malaysia and Indonesia, the overseas Chinese communities have long played dominant roles in the economy and governments have felt compelled to hold their power in check by giving special preferences to indigenous business groups. In the case of Malaysia, this policy led to a sophisticated affirmative action programme which produced a new Bumiputra business elite closely aligned to prime minister Mahathir. In the case of Indonesia, it led to the creation of numerous cartels for groups aligned to the children of former president Suharto or other members of his family.

The good performance of the Australian economy during the past year is testimony to how important a role microeconomic policy has played in shaping the parameters of the recent crisis. At first glance, Australia would appear to be quite vulnerable to the same factors which destabilized Asia. The country's major exports are commodities and two thirds of them go to the east Asia region. Australia has long run a current account deficit and thus is vulnerable to

sudden changes in the direction of global capital flows. Yet, Australia has been able to achieve a growth rate of nearly 4.0 per cent during the past year despite a 30 per cent decline in the value of the Australian dollar and deterioration in many of her important export prices. How did Australia manage to sustain high growth in the face of such adverse fundamentals? Several factors contributed to her good performance. First, Australia improved her bank supervision after a boom-bust lending cycle during the 1980s, when financial deregulation had encouraged foreign banks to enter the market for the first time and engage in a reckless battle for market share. Secondly, Australia has long had a floating exchange rate. This policy has discouraged Australian firms from borrowing heavily in foreign currencies unless they also have offshore income. Thirdly, during the 1980s Australia significantly liberalized her trade and industrial relations policies. These structural changes have made her economy far more flexible in coping with external shocks. In the 1980s, by contrast, Australia was much more vulnerable to Asia-style shocks than have occurred recently. In that period, she had opened her banking system to foreign competition for the first time. The arrival of sixteen foreign banks encouraged such aggressive competition to make loans that many bankers ended up financing property speculation or corporate raiders such as Alan Bond. The central bank found it difficult to control such lending despite high interest rates until the raiders themselves became so over-leveraged that they simply went bankrupt. In retrospect, the Australian experience of the 1980s was a forerunner of the banking excesses which set the stage for the Asia crisis of the late 1990s. But since Australia had a volatile exchange rate throughout this period, its corporate sector never became as over-leveraged in foreign currencies as did the Asian corporate sector.

Since it was microeconomic failures which set the stage for the recent financial crisis in developing countries, it will be developments in bank regulation and corporate governance which determine how rapidly they can recover. The good news is that there have been policy initiatives announced by countries in Asia, Latin America, Africa and eastern Europe during the past twelve months aimed at correcting the microeconomic factors which caused the crisis.

First, many countries are now opening up their financial sectors to much higher levels of foreign investment than ever before. Argentina now has almost half of its banks' assets in foreign-controlled institutions. Estonia's two largest banks will soon be foreign-controlled. Thailand has just begun the process of bank recapitalization but the financial sector will probably be at least half foreign-owned in three years' time. The same will probably be true of Indonesia. What is striking is how the countries with currency boards are going the furthest in permitting foreign investment in their banks. They recognize that with their domestic central banks unable to play the role of lender of last resort, their monetary stability is enhanced by having high levels of foreign ownership and potential access to a lender of last resort in Washington, Frankfurt, or London. Indeed, Argentina's Government has responded to the crisis in Brazil, by announcing that it may formally dollarize the economy and seek a treaty with the U.S. which would enthrone the Federal Reserve as its lender of last resort.

Secondly, countries which previously restricted all forms of foreign investment, such as Korea, are opening their door to foreign capital on an unprecedented scale. Both Korea and Thailand attracted about \$8 billion of foreign direct investment during 1998 despite the fact that the total stock of FDI in Korea is only about \$12 billion compared to numbers three or four times as high in most ASEAN countries. The big *chaebols* (the biggest conglomerates in South Korea) were initially hostile to foreign investment and have tried to discourage bids in sensitive sectors such as

the auto industry, but the Korean Government has forced them to accept both foreign investment and more aggressive domestic restructuring. Such changes will promote more efficient allocation of investment by the Korean corporate sector itself. Both the IMF and the Group of Seven are committed to producing improvements in corporate disclosure and transparency which should strengthen the role of shareholders in other Asian developing countries as well. Asia will never fully embrace the Anglo-Saxon model of capitalism but the new emphasis on transparency and openness can only enhance the ability of shareholders to influence management decision making.

Thirdly, many governments are adopting sensible microeconomic policies to help their corporate sectors cope with both the recession now underway in their economies and the difficulties of obtaining access to the global capital market. Singapore has announced a large tax cut specifically to bolster corporate profits while announcing rationalization programmes for large State dominated companies, such as the Keppel Groups which have been suffering from poor profitability. Korea has repealed many restrictive labour laws in order to permit firms to restore profitability through restructuring. South Africa's Government is permitting the Anglo American group to redomicile itself in London in order to obtain better access to the global financial markets. In the past, the Anglo American Corporation had been regarded as a potential target for nationalization by both Afrikaner and African nationalist political movements, so the Government's acceptance of the change in domicile has to rank as one of the most extraordinary corporate developments in the recent emerging market crisis. South Africa is also adhering to her previously announced policy of privatizing large State-owned enterprises despite the recent turmoil in financial markets.

Fourthly, developing countries with high interest rates and stable exchange rates are trying to find new ways of discouraging their corporate sectors from over-leveraging in the United States dollars in the way that Asian companies did during the first half of

the 1990s. Poland, for example, has recently widened the target band for its currency in order to create more exchange rate uncertainty at a time when its high short-term interest rates (18-19 per cent) are encouraging Polish companies to borrow more heavily in dollars and Deutsche-Marks. Polish companies have borrowed nearly \$12 billion in foreign currency since 1996 because of the country's high interest rates and relatively stable currency, so the central bank is anxious to remind them that it is not offering any guarantees of exchange rate stability.

Fifth, many developing countries are trying to reduce their dependence upon foreign capital inflows by promoting the development of pension funds. Ten years ago, Singapore and Malaysia were the only developing countries with large pension fund sectors. Chile followed in their footsteps during the late 1980s and has encouraged imitation in countries as diverse as Argentina, Mexico, Thailand, Hungary, and Poland. If this trend continues, there could soon be more stock-holders in the developing countries than in the old industrial countries. Such a development will encourage further growth of both domestic savings and the capitalization of the debt and equity markets of the developing countries. The growth of pension fund ownership of corporate equity will also create an important constituency forcing managements to focus more attention on corporate profitability. In the past, by contrast, Asian corporate managements were typically accountable only to families, banks or governments.

One striking example of the change now occurring in shareholder-management relations was the decision of the Chinese red chip company, Shanghai Industrial, to abandon plans to purchase hotels from its parent company after complaints from

minority shareholders. Under the rules of the Hong Kong market, minority shareholders have to approve transactions between listed companies and their parent companies. The minority shareholders felt the proposed price was too high and thus challenged the management of Shanghai Industrial. The precedent they set was an important one because it will now force all Chinese companies to be more sensitive to minority shareholder opinions despite the fact that the government often retains a large shareholding in newly listed companies.

China's equity market has grown from nothing in 1990 to over \$250 billion today but many of her leading companies have had to use offshore listing in Hong Kong and New York in order to obtain capital because there are still exchange control restrictions on foreigners investing directly in the Shanghai or Shenzhen markets. Chinese companies in the domestic market still offer less protection for shareholders than the companies listed offshore, but China will also have to enhance the rights of minority shareholders at home as it develops a larger population of shareholders and investment institutions such as pension funds.

The microeconomic reforms now occurring in the developing countries will take several years to become fully effective. Concepts such as foreclosure and bankruptcy are still much less developed in the legal systems of Thailand, Indonesia and other developing countries than in countries which were formerly part of the British Empire. Their parliaments still have a great deal of legislation to enact while their courts must learn how to administer the new laws in an impartial manner. But the trend of the reforms resulting from the crisis are very clear. There will be far more convergence in standards of corporate disclosure, systems of financial supervision, and legal definitions of property rights between the developing

countries and the industrial countries than has ever existed before. As the Texas and New England banking crises of the 1980s will testify, such microeconomic reforms cannot guarantee that the developing countries will never again experience banking crises but they will greatly lessen the risk of the factors which caused the recent financial contagion from recurring. The one legacy of the Asian crisis which may not be possible to correct in the short term is the risk that there will be inadequate capital spending by banks and companies on the Y2K problem and severe system failures in year 2000.

The effort of the G-7 Governments to turn the IMF into more of a crisis prevention agency rather than merely a lender of last resort during crises should also help to insure that the structural reforms now occurring persist. There is always a risk that some countries will attempt to withdraw from the international system rather than reform, but so far only Malaysia has embarked upon a clearly isolationist policy. The fact that its currency has not shared in the recent rally of other Asian currencies suggests that it is unlikely to attract many imitators. On the contrary, countries which have long restricted capital inflows through special penalties, such as Chile, have recently reduced those barriers.

The one problem which governments in emerging market countries cannot easily correct is liquidity. During the past few years, global stock markets have had an increasingly two-tier character in which large capitalization companies have significantly out-performed small capitalization companies. In the case of the U.S., the divergence in rate of return on the basis of company capitalization has been as great as 20-30 per cent during the past two years. Since emerging market companies often have small market capitalizations and less liquidity than the companies in the OECD countries, their valuations can suffer as well. In fact, a research paper produced by the World Bank as long ago as 1993 found a strong correlation between stock

market liquidity and economic growth in many developing countries. Ross Levine and Sara Zervos examined the role of stock market development on economic growth in 41 countries during the period 1976 to 1993. A subsequent report for the Investment Company Institute explained:

“Stock markets contribute to economic development by enhancing the liquidity of capital investments.⁴⁷ Many profitable investments require a long-term commitment of capital, but investors might not want to tie up their savings for such long periods. A liquid equity market allows savers to sell their shares easily if they so desire, thereby making shares relatively more attractive investments. As savers become comfortable with investing for the long-term in equities, they are likely to rebalance their portfolios towards equities and away from shorter-term financial investments. For firms, this rebalancing lowers the cost of shifting to more profitable – that is, more productive – longer-term projects. Higher-productivity capital, in turn, boosts economic growth. It also increases returns on investments in equity which may prompt individuals to save more, adding further to investment in physical capital and thus fueling economic growth.”

“However, some economists argue that very liquid markets hurt economic development. By allowing investors to sell stock quickly, liquid markets may reduce investor commitment and reduce incentives of stock owners to exert corporate control by monitoring the performance of managers and firms.⁴⁸ In other words, dissatisfied owners sell their shares instead of working to make the firm operate better. According

⁴⁷ See Ross Levine (1991) Stock markets, growth and tax policy, in *Journal of Finance*, September, and Ross Levine (1997) Financial development and economic growth: views and agenda, in *Journal of Economic Literature*, June.

⁴⁸ See Andrei Shleifer and Robert Vishny (1997) A survey of corporate governance,” *Journal of Finance*, September.

to this view, greater stock market liquidity may impede economic growth by hindering corporate governance.”

“But recent evidence suggests that well-functioning equity markets accelerate economic growth.⁴⁹ This evidence is based upon the relationship between indicators of stock market liquidity and economic growth. Consider, for example, the total value of the trading volume of a country’s stock exchanges expressed as a share of the country’s gross domestic product (GDP). This value-traded ratio does not directly measure the costs of buying and selling securities at posted prices. Yet, averaged over a long time, the value-traded ratio is likely to vary with market liquidity, that is, with the ease of trading. If it is costly and risky to trade, there will tend to be less trading.”

“...The turnover ratio, which equals the total value of shares traded as a share of market capitalization, is [also] a good forecaster of economic growth. Liquidity also can be measured as the value-trade ratio divided by stock price volatility. More liquid markets should be able to handle high volumes of trading without large price swings. This measure of liquidity also shows that countries with more liquid stock markets tend to grow faster.”

“Other measures of stock market development appear not to account for economic growth as well as liquidity. There is no evidence that higher stock market volatility adversely affects growth. Nor does there seem to be a strong link between the size of the stock market in a country, as measured by market capitalization divided by GDP, and economic growth.⁵⁰ Liquidity –

⁴⁹ See Ross Levine and Sara Zervos, “Stock Markets and Banks: Revving the Engines of Growth, World Bank Policy Research Working Paper No. 1690

⁵⁰ Regression results fail to show a significant statistical relationship between market volatility and economic growth. A significant positive relationship between stock

the ability to buy and sell equities easily – exhibits the strongest connection to long-run growth.”

If the paper had used data for the period through 1998, it probably would have found that liquidity was even more influential during the past two years than it was previously. The fact is that many institutional investors, such as mutual funds, are so concerned about liquidity that they are prepared to pay a much higher price for companies which they perceive to be liquid than those which are not. The events of 1997 and 1998 can only reinforce this obsession with liquidity during the short to intermediate term.

The new preoccupation with liquidity has important implications for governments which want to promote stock market development in order to improve the allocation of domestic savings to obtain more foreign capital. It means they should use their privatization policies to promote stock market listings of large capitalization companies, such as telephone companies, utilities, or national banks. It is important to privatize such firms because in many developing countries they tend to have the largest stock market capitalizations and thus can serve as a magnet for foreign portfolio investors. In the absence of such listings, the risk is high that foreign investors will simply by-pass the market even if the local commercial and industrial companies sell at discounts to their counterparts in other countries with larger stock market capitalizations.

The region which should most obviously focus upon privatization of utilities and telecom companies in order to boost stock market capitalization is Africa. There are

market size and economic growth is found, but these results depend crucially on the inclusion of three countries; significance disappears if these countries are omitted from the sample. See Levine and Zervos, *ibid.*

now five small but active markets in Zimbabwe (\$2.8 billion), Kenya (\$2.0 billion), Ghana (\$2.0 billion), Mauritius (\$1.7 billion) and Cote d'Ivoire (\$1.2 billion). Except for the Ashanti Gold Mine which is also listed in New York, these exchanges are dominated by banks and commercial companies which have only modest market capitalizations. The lack of liquidity in these markets discourages overseas portfolio investment compared to the potential which would exist if they had utility and telephone companies with market capitalizations of several hundred million dollars each. Governments have talked about privatizing such sectors but so there has been little follow through except to sell large stakes in a few companies to foreign strategic investors (Zimbabwe, South Africa).

In 1990, the emerging market countries had a stock market capitalization of only \$613 billion compared to \$8.8 trillion for the industrial countries. In 1996, this market capitalization peaked at \$2.1 trillion compared to \$18.1 trillion for the industrial countries. After the Russia crisis, the market capitalization of the developing countries slumped to only about \$1.6 trillion compared to a peak of nearly \$25 trillion for the industrial countries in July. As a result of the price declines of the past year, the emerging market countries now account for only about 6 per cent of global stock market capitalization despite the fact that they represent 45 per cent of global output, 70 per cent of the world's land area, 85 per cent of the world's population, and 99 per cent of the projected growth in the global labour force during the early decades of the 21st century.

Such an imbalance between stock market capitalization's and economic endowments cannot be sustained indefinitely if the emerging market countries pursue effective

microeconomic reforms. As a result, the odds are high that the current crisis will be viewed as a secular turning point. It will probably go down in the history books as the event which crushed the naïve investor optimism of the years immediately after the cold war while laying the foundation for the establishment of much stronger systems of financial supervision and protection of shareholder rights than have ever existed before in the developing countries. When the world business cycle turns upward in twelve or eighteen months, these microeconomic reforms should set the stage for emerging markets to produce superior investment returns on a more sustained basis than was possible amidst the turbulent global capital flows of the 1990s.

WORLD MARKET CAPITALIZATION

(US\$ millions, end of period levels)

Market	1988	1993	1997
Emerging Markets			
Argentina	2,025	43,967	59,252
Armenia	-	-	16
Bangladesh	430	453	1522
Barbados	-	328	1141
Bermuda	-	-	1411
Bhutan	-	-	28 (1996)
Bolivia	-	-	344
Botswana	-	261	613
Brazil	32,149	99,430	255,478
Bulgaria	-	-	2
Cayman Islands	-	-	44
Chile	6,849	44,622	72,046
China	-	40,567	206,366
Colombia	1,145	9,237	19,529
Costa Rica	-	434	820
Côte d'Ivoire	437	414	1,228
Croatia (FYR)	-	-	4,246
Cyprus	-	981	2,011
Czech Republic	-	-	12,786
Dominican Republic	-	-	140
Ecuador	-	1,098	2,146
Egypt	1,760	3,814	20,830
El Salvador	-	-	499
Estonia	-	-	1,008
Fiji	-	-	93
Ghana	-	118	1,130
Greece	4,285	12,319	34,164
Guatemala	-	-	139
Honduras	-	-	338 (1995)
Hungary	-	812	14,975
India	23,623	97,976	128,466
Indonesia	253	32,953	29,105

Market	1988	1993	1997
Iran	-	1,304	15,123
Israel	5,458	50773	45,268
Jamaica	796	1469	2,206
Jordan	2,233	4891	5,446
Kenya	474	1060	1,811
Korea	94,238	139,420	41,881
Kuwait	11,836	10,049	25,888
The Kyrgyz Republic	-	-	-
Latvia	-	-	337
Lebanon	-	-	2,904
Lithuania	-	-	1,706
Malaysia	23,318	220,328	93,608
Mauritius	-	791	1,663
Mexico	13,784	200,671	156,595
Mongolia	-	-	54
Morocco	446	2,651	12,177
Namibia	-	28	689
Nepal	-	-	200
Nigeria	960	1,029	3,646
Oman	-	1,088	7,108
Pakistan	2,460	11,602	10,966
Palestine	-	-	662
Panama	-	419	2,175
Paraguay	-	24	389
Peru	-	5,113	17,586
The Philippines	4,280	40,327	31,361
Poland	-	2,706	12,135
Portugal	7,172	12,417	38,954
Romania	-	-	630
The Russian Federation	-	18	128,207
Saudi Arabia	-	52,773	59,386
Slovakia	-	-	2,826
Slovenia (FYR)	-	-	1,613
South Africa	126,094	171,942	232,069
Sri Lanka	471	2,498	2,096
Swaziland	-	297	129
Taiwan, China	120,017	195,198	287,813

Stock Market Growth and Privatization in Developing Countries

42

Market	1988	1993	1997
Thailand	8,811	130,510	23,538
Trinidad & Tobago	268	485	3,117
Tunisia	612	956	2,312
Turkey	1,135	37,496	61,090
Ukraine	-	-	3,667
Uruguay	--	251	212,212
Uzbekistan	-	-	465
Venezuela	1,816	8,010	14,581
Yugoslavia	-	-	-
Zambia	-	-	705
Zimbabwe	774	1,433	1,969
IFC index Markets	488,573	1,631,835	2,096,878
All Emerging Markets	500,409	1,699,811	2,229,508
<u>Developed Markets</u>			
Australia	138,283	203,964	696,656
Austria	8,862	28,437	35,724
Belgium	58,920	78,067	163,965
Canada	241,880	326,524	567,635
Denmark	30,178	41,785	93,766
Finland	30,179	23,562	73,222
France	244,833	456,111	674,368
Germany	251,777	463,476	825,233
Hong Kong	74,377	385,247	413,323
Iceland	-	-	1,210 (1996)
Ireland	-	-	24,135
Italy	135,428	136,153	344,665
Japan	3,906,680	2,999,756	2,216,699
Luxembourg	44,808	19,337	33,892
The Netherlands	113,565	181,876	468,736
New Zealand	13,163	25,597	90,483
Norway	14,332	27,380	66,503
Singapore	24,049	132,742	106,317
Spain	91,118	119,264	290,383
Sweden	100,083	107,376	272,730
Switzerland	140,527	271,713	575,338
The United Kingdom	771,206	1,151,646	1,996,225

Market	1988	1993	1997
<u>The United States</u>	2,793,816	5,136,199	11,308,779
<i><u>Developed Markets</u></i>	9,228,064	12,316,212	21,311,877
<u>WORLD TOTAL</u>	9,728,473	14,016,023	23,541,385

Aggregate Net Long-Term Resource Flows to Emerging Markets									
<i>(U.S. \$ billions)</i>									
<i>Type of Finance</i>	1985	1986	1987	1988	1989	1990	1991	1992	19
Official Development Finance	37.8	42.9	43.4	42.2	42.6	56.4	62.7	53.8	53.6
Private Debt Flows	21.8	10.9	9.8	12.7	12.8	15.0	13.5	33.8	44.0
Commercial Banks	8.5	3.3	3.0	7.3	0.9	3.8	3.4	13.1	2.8
Others	7.6	6.3	5.0	1.4	3.1	11.1	2.7	12.4	9.4
Portfolio, Equity	0.1	0.6	0.8	1.1	3.5	3.2	7.2	11.0	45.0
Foreign Direct Investment	11.3	10.3	14.6	21.2	25.7	23.7	32.9	45.3	65.6
Total Private	33.3	21.7	25.2	35.0	41.9	41.9	53.6	90.1	154.
Aggregate Net Resource Flows	71.1	64.6	68.5	77.4	84.5	98.3	116.3	143.9	208.
Of which official (per cent)	53.2	66.3	63.3	54.8	50.4	57.4	53.9	37.4	25.7
Of which portfolio, equity	0.2	0.9	1.1	1.4	4.1	3.3	6.2	7.6	21.6

Source: World Bank, Global Development Finance 1998

V. THE POLITICAL ECONOMY OF PRIVATIZATION

A. Introduction

In dealing with a topic like this, there are many possible approaches to follow. In the book that I co-authored with Mary Shirley called *Bureaucrats in Business* we have a chapter on the political economy of reform and privatization of public enterprise in which we tried to answer the following question. Why is it that we observe that some countries privatize and others do not or lag behind? We came up with three preconditions for privatization. The first condition is that political leaders have to find reform politically desirable, in the sense that politicians like to advance not only the interest of the nation but also the interest of their supporters. Second, they should find the reform politically feasible. Finally, they have to ensure that it is credible.

On the first condition, how can a politician make privatization beneficial to his supporters? This depends on the details. What will make a reform politically feasible will depend on whether the politician is a dictator, or at least whether he has a majority in parliament. And one can design privatization in ways to make it feasible, so that opponents can be bought out in some sense. Workers typically are the ones who will oppose the sale of a firm, so giving them shares at a discount is one way of buying political support.

The last condition about credibility is important because the benefits and costs occur over a period of time, so you need to make promises and your promises have to be credible. If people do not believe that you are going to deliver on your promises, either to compensate them for losses or to reward them with gains, they will not go along with the process.

If a policy maker, a politician, wants to sell a privatization programme, what approaches does he or she have and which approach is best? Basically this is about the alternatives to selling privatization politically. Privatization fundamentally has to do with winners and losers, so one has to deal with this issue. There are three reasons why one should worry about the politics of privatization. The first reason is that the potential losers can actually stop one from privatizing in the first place, so one has to worry about the losers in order to get the process going. The second reason, as we heard from the Russian experience, arises when privatization leads to polarization, or mass redistribution of assets or when it hurts the society in a very significant way. Even though the losers may not see their losses immediately, they may feel them later. This can create a backlash and erode the sustainability of privatization reform. In fact it can create problems for reforms in general beyond privatization. If you do privatization badly it hurts people and they oppose reform of whatever kind. And then the third point is that distribution is important in its own right. It is not enough to worry about efficiency and growth; one really needs to worry about income distribution and there is no trade-off between the two. It is no longer true to say, let me grow now and then I will worry about distribution later. It is not necessarily true.

If you are convinced as I am that it is important to worry about politics, then what can you do about it? There are three ways of dealing with privatization politically. The first is what I call *political optimality* and that approach is not likely to succeed. The second one is called *ex post analysis* and that is partially successful. The last is *ex ante stakeholder analysis*, and this offers the best chance for success.

B. Political optimality

Pareto optimality refers to a situation where you can not make someone better off without making somebody else worse off. *Political* optimality I define as a situation where no-one can be made better off without making somebody else *aware* that he or she is worse off. This is also called bluffing. Basically, if you can get the deal going and some people are going to lose but you can make sure they do not see they are going to lose, that is political bluff. This is what the Russian ex-perience shows, the second wave of privatization in particular, the so-called loans-for-shares scheme. We had a course on privatization for two weeks that we organized for the Economic Development Institute with a video by Jeffrey Sachs from Cambridge. He was asked about privatization in The Russian Federation and he replied that he thought that the second wave of privatization in The Russian Federation should lead to nationalization and then reprivatization because what had happened was not privatization in the first place. So that is where bluffing can lead you. But actually the story is a lot more serious than that because it applies in a lot of countries, not only in The Russian Federation. We are all familiar with Telebras, the Brazilian telecommunications utility. There was a newspaper report that the Brazilian Prime Minister talked to a buyer and there was some sort of an arrangement whereby the company was being sold but under conditions that were a bit suspicious. Privatization is often undertaken under suspicious conditions. The political approach is to get the deal done and don't ask how. That is not a sustainable solution. It might get the privatization going but it will not make it really last. As a political approach that is short-sighted.

C. Ex post analysis

So what is a better approach? As I said, there are three approaches; one is bluffing, the second is ex post analysis by which I mean trying to learn from the experience of other countries, who won and who lost, and using that experience to design a privatization programme which will achieve a balance between the winners and the losers. I am going to illustrate that approach and try to uncover the conditions which make for the distribution of benefits and losses from privatization by giving you the results of a study I made with a few other people in 1992 that came out in a book called *Welfare Consequences of Selling Public Enterprises*. That study was useful because it revealed who won and who lost in very specific cases and the underlying conditions which caused those results. We took four countries with a sufficient history of privatization that we could look at its impact after the sale. The countries were The United Kingdom, Chile, Malaysia and Mexico. We took three big companies in each country. Some of these companies represented whole sectors like telecom companies. The company would be the sector. In the UK, we took British Telecom, British Airways and National Freight; in Chile, we had two electric companies and one telecom company, and in Malaysia we had an airline, Kelang container terminal and a lottery called Sports Toto, while in Mexico we had Teléfonos de Mexico, Aeroméxico and Mexicana de Aviación.

It is one thing to say that privatization had a positive or negative impact. It is another thing to take account of a lot other complications such as dynamic effects. In other words, the benefits and costs are not just those of today but today, tomorrow and the day after tomorrow. One needs to worry about time, not just look at today and say it looks fine. One has to worry about trade-offs because consumers can be impacted in one way and workers in another way. One wants to find the net gain to society but one also wants to find out who is getting what. One needs to think about what we call the counterfactual. That is, when a government privatizes, that is not the only thing that takes place. Other things happen too. The world does not come to a halt. The government does a lot of other things while it is privatizing—it is liberalizing trade, it is doing something on the fiscal side, and so

on. There are many other concurrent factors and it is necessary to isolate the effect of the change of ownership from the effect of these other contemporaneous factors. We took all the factors into account. We took the performance of the company before and after privatization for five years, trying to identify kinks in performance trends, and asking the question, is this change due to privatization or something else? We assumed that changes were due to something else unless proven otherwise. In other words we took a very conservative position to measure the impact of privatization. Once we were convinced that a particular change was due to privatization, we projected it into the future, so we obtained two scenarios: (1) the company continuing the old trend line under public ownership, and (2) the privatized company continuing into the future. We discounted the two projections to two present values, we subtracted one from the other to get one number and that number is what we call the welfare impact.

Next we disaggregated the welfare impact in two ways. The first determined where the welfare change came from? Was it from productivity improvement? Was it from new investment? Was it from a price change? Then we analysed who actually got the gains and who paid for them. Was it the workers, the consumers, the government, the buyers, who? We even took the competitors into account. Sports Toto, the lottery company in Malaysia, gets a lot of advertising. After the company was privatized, they advertised heavily on television and increased their market share. They made a lot of money and paid a lot of taxes to the Government, but at the same time the other lottery companies were losing. In a social sense, the company was doing very well but not necessarily society as a whole because other companies were losing. So we took competitor impacts into account as well. Figure 1 shows the results of this very complicated exercise, which took us two years. If the black bar is on the right, it is a positive impact of privatization and if it is on the left it is a negative welfare impact. The white bar represents the gains to foreigners. Where there is no white bar it is because the amount of foreign gains was insignificant. The important statistic is total gains excluding foreigners because, as we all know, people should be thinking about the welfare of their country not of the world. Privatization should serve the national interest, not the welfare of the world interest.

The domestic/foreign break-down is an important issue for another reason. Typically, people say that privatizing is selling the national jewels to foreigners, so that concern has to be addressed. Then the government can say "Certainly we are getting foreigners but at the same time we are benefiting from it". If you are creating a positive-sum game in which both sides are gaining, you are doing a good job. You are trying to convince people that they should not worry about it so much.

It will be seen that all the black bars are on the right and in only one case (Mexicana Airline) it is on the left. In other words, privatization improved welfare the way I describe in 11 out of the 12 cases. What happened in the Mexicana case was that privatization did not work. It actually made Mexico worse off than if the company had not been privatized. In that particular case the buyer had resort areas and he thought he was going to get Americans on his own airline, take them to his resorts on a package deal and really make a lot of money. He invested very heavily at the beginning, bought 50 airplanes and painted them, but the Americans did not come. He had another problem as the planes became heavy after the work done on them. At any rate he made the wrong investment decision and he paid for it. Is that a failure of privatization or a success of privatization? The people who think that the success of an economic system lies in its ability to restructure and meet new challenges say that this case was a successful privatization. In a sense, obviously Mexico lost so that cannot be debated, but at the same time it tells you that the private sector has to adjust or die and that applies to society as well.

I am going back now to the distribution between foreign and domestic. The cases where foreigners gained a lot (where the white bars are long) are in Telmex and Malaysian Airline. You can influence the distribution of the benefits between foreign and domestic depending on the sale process and that is an issue I will return to when I talk about the government. Remember that I am trying to convince you that as a politician you can look at the experience of other countries, identify the winners and losers, see

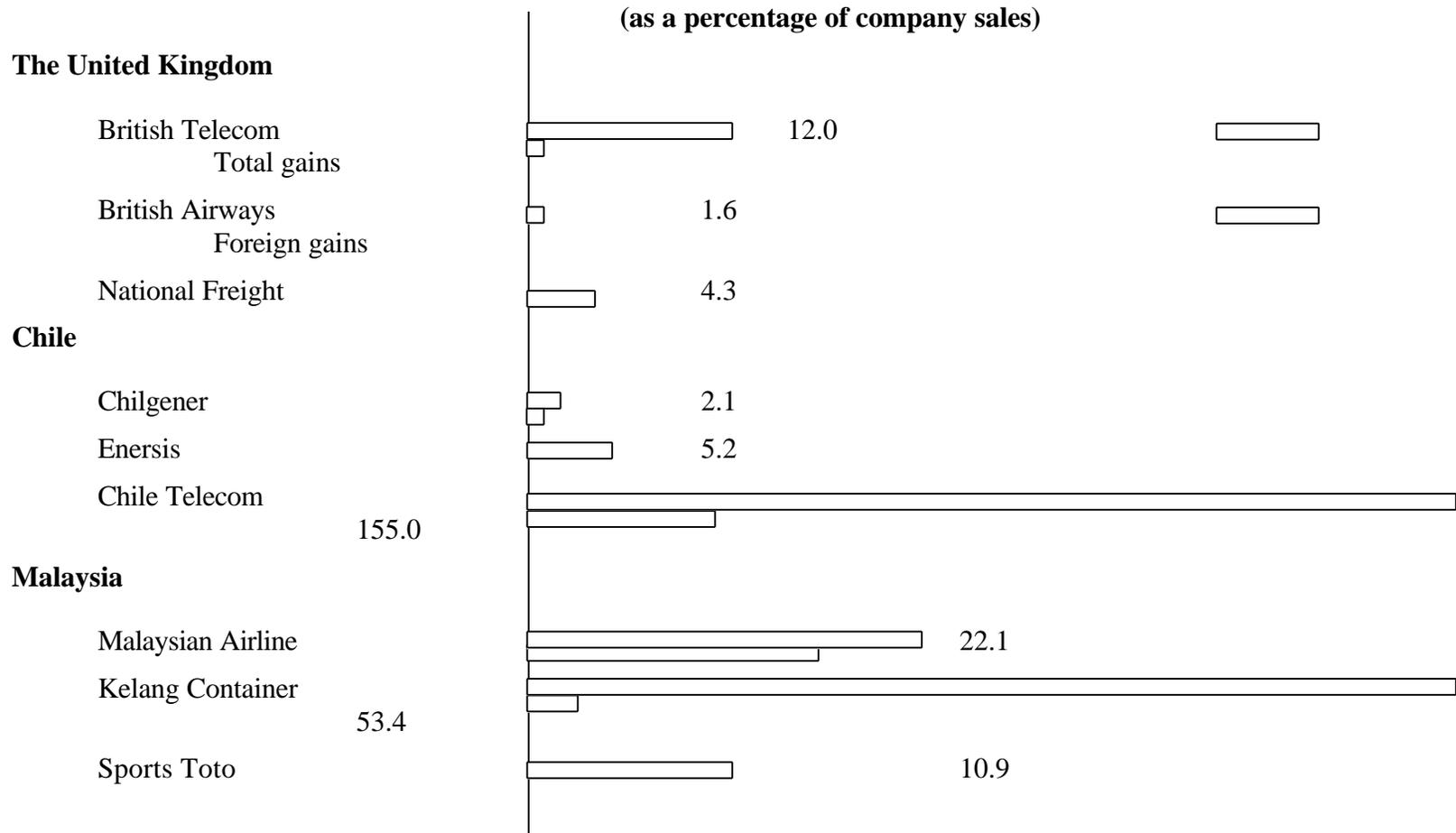
how they made sure that domestic consumers did not lose and then try to imitate those conditions so that they can tell the people, for instance, “In Mexico, consumers won because they did this and that. That is what I am going to do so you are going to be in a good shape. Don’t worry”. That is why I am telling you all these details.

Now I consider the buyers. You will notice (figure 2) that the buyers in almost all cases are on the right hand side: all the private buyers made money except in the case of Mexicana Airlines, as I explained before. Buyers are very careful—you do not have to worry about them. They send a small army of analysts to your company, they ask lots of questions, they look at the machines, they look at the market, they do all sorts of calculations, they do a full study. The government need not worry about buyers whether they are domestic or foreign.

Next I come to the impact on the government. Let me explain to you how we did the calculation because it is not always apparent. The way we calculated the fiscal impact of privatization is by looking at what the government would have received had it not privatized and kept the company publicly-owned. In that case, the government would have got dividends, also taxes, and they would get the earnings retained in the company because after all the company is owned by the government and these would be part of the residual value of the firm once it dies. On the other hand, if the government had been subsidizing the company, it would have to continue to pay subsidies. That stream shows what the treasury would have received if it had kept the company under government ownership. Compare that with the second scenario which is based on privatization. What does the government get? It gets the sale price and it gets a stream of taxes on the profits from the company over time. We discount the cash flows from each of these scenarios and get two numbers, we subtract one from the other and get one number and that is what you see here (figure 3).

Figure 1

Overall Gains and Foreign Gains



Mexico

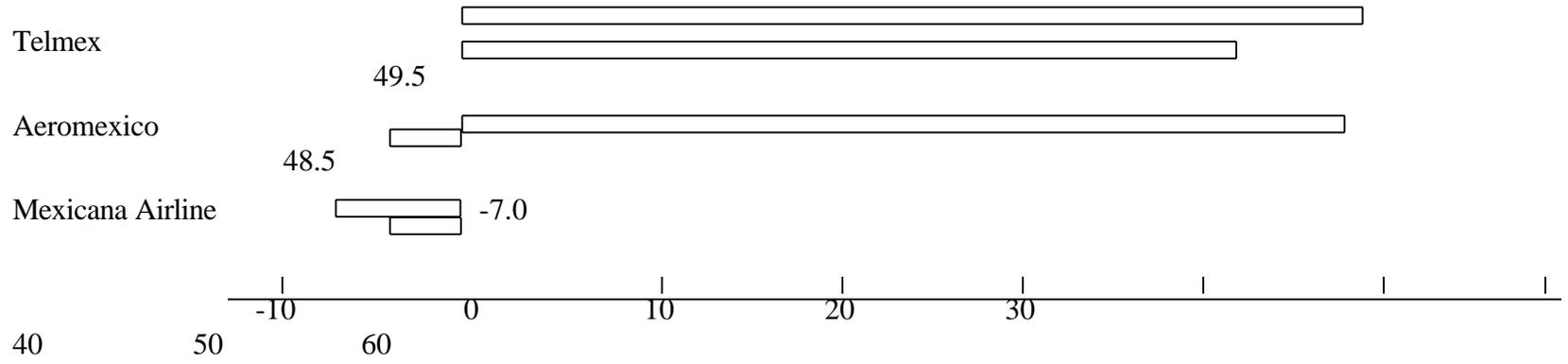
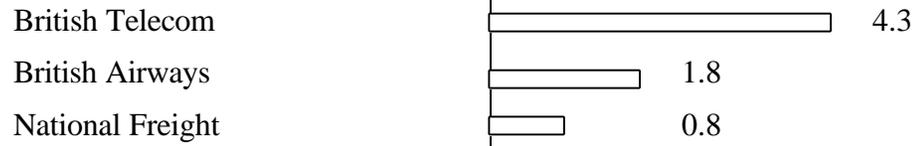


Figure 2

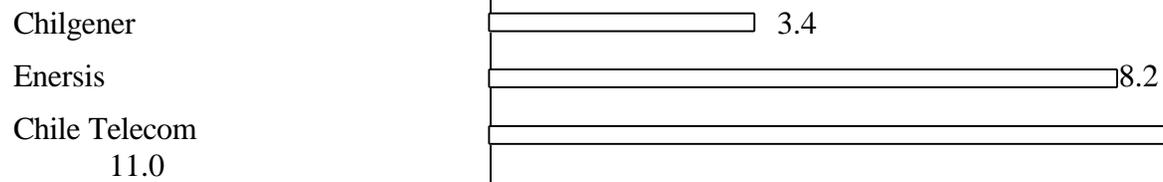
Impact on Buyers

(as a percentage of company sales)

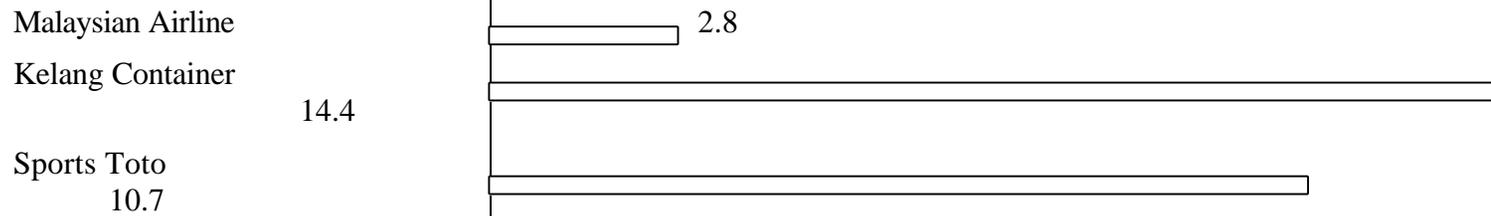
The United Kingdom



Chile



Malaysia



Mexico

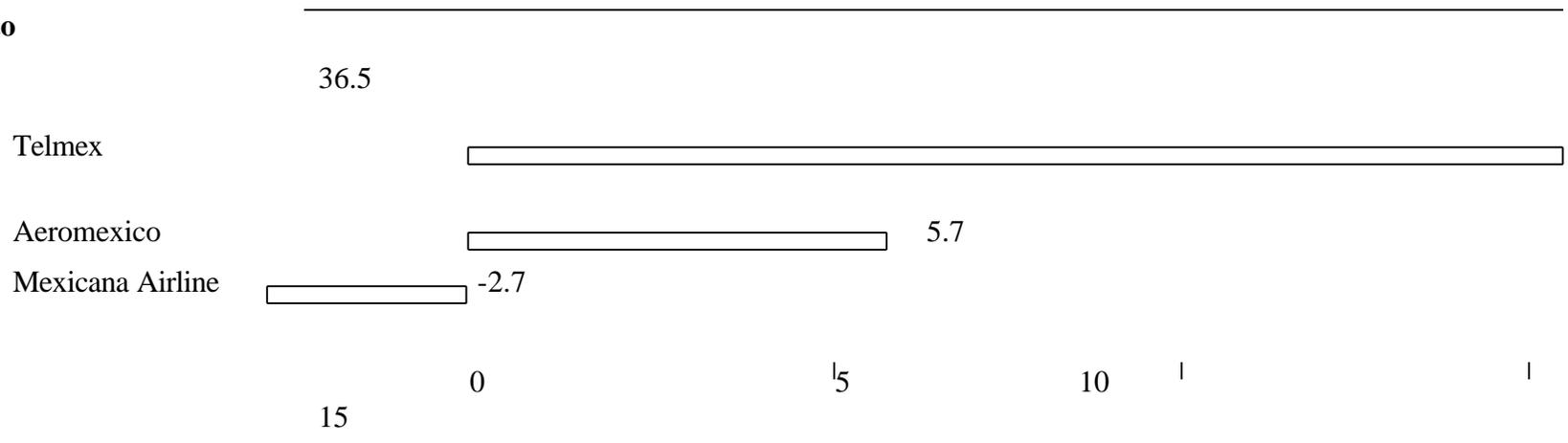
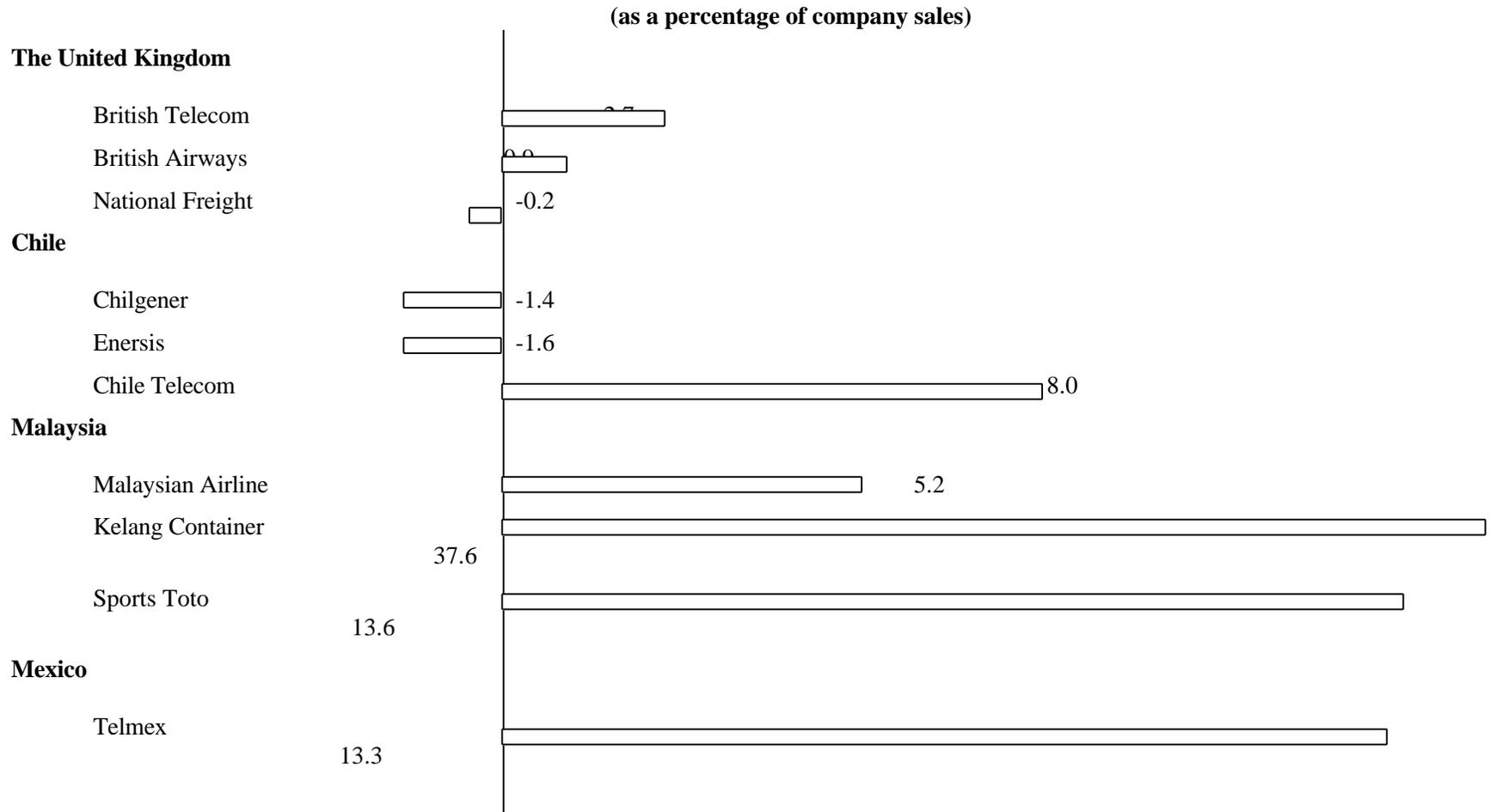
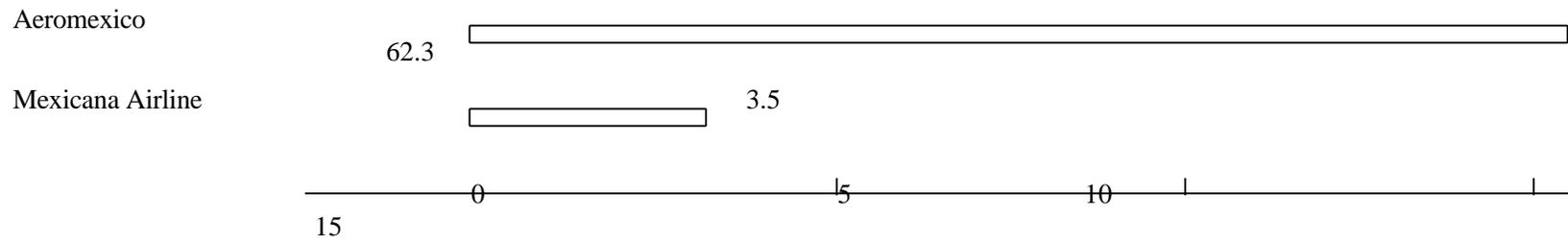


Figure 3
Impact on Governments





Source: Galal and others (1995), op. cit.

Figure 4
Impact on Workers

The United Kingdom

- British Telecom
- British Airways
- National Freight

Chile

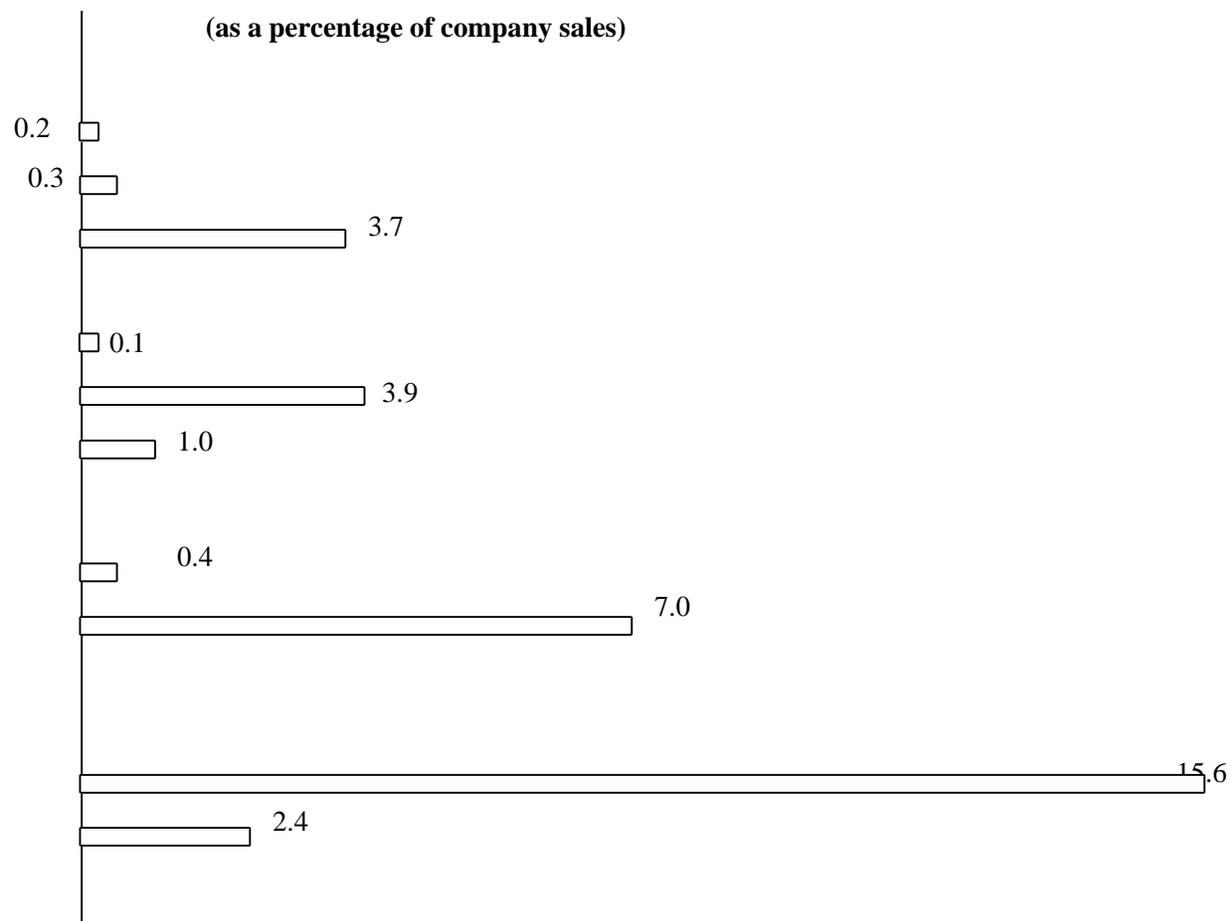
- Chilgener
- Enersis
- Chile Telecom

Malaysia

- Malaysian Airline
- Kelang Container
- Sports Toto

Mexico

- Telmex
- Aeromexico
- Mexicana Airline





Source: Galal and others (1995), Welfare Consequences of Selling Public Enterprises, Oxford University Press

Figure 5

Impact on Consumers

The United Kingdom

- British Telecom
- British Airways
- National Freight

Chile

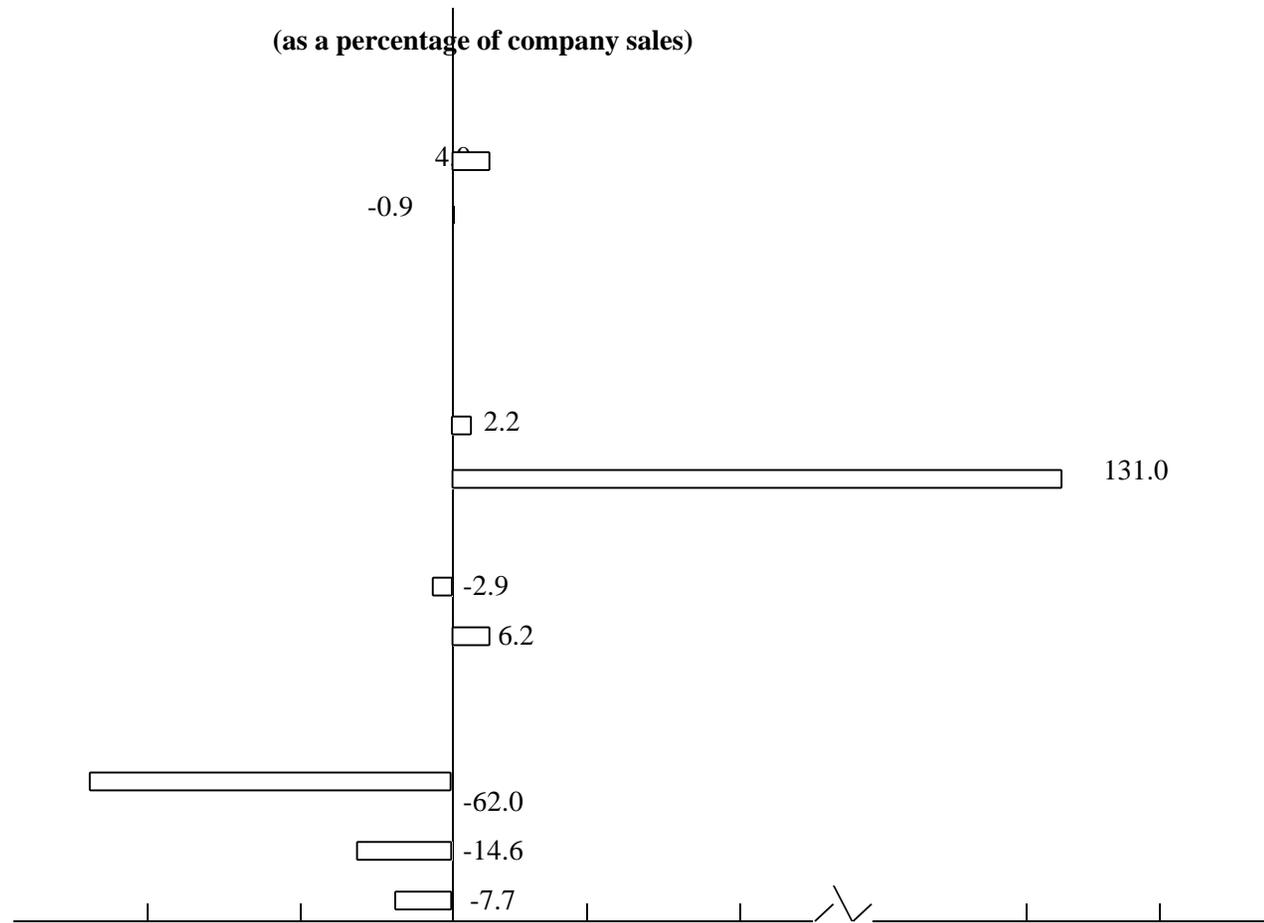
- Chilgener
- Enersis
- Chile Telecom

Malaysia

- Malaysian Airline
- Kelang Container
- Sports Toto

Mexico

- Telmex
- Aeromexico
- Mexicana Airline



-50 -25 25 50 125 150

Every time the number is on the right hand side this is a positive impact on the treasury. It is a dynamic measure covering a long period of time, not just a one-time affair. We are not only looking at the price. The fiscal impact ranges from very positive, especially in Mexico, to modestly negative in the cases of two power companies in Chile. By and large, we have found out that what really counts is that the more open the bidding and sale process, the more bidders you have, the higher the price and the more positive the impact on the treasury.

Workers in the companies that we looked at were all better off after privatization. Remember that some workers do leave and they are compensated but the majority of the workers stayed in the company, got higher wages and shares at a discount. When you compare their status quo where they would have been working less and getting low salaries, and working hard, getting high salaries and discounted shares, with compensation for those who left, the bottom line is positive for workers. What that also says is that you can design your programme and tell the workers: "In Chile they compensated the workers in such a way that actually they were not worse off. I can do it the same way. I can make sure that you can be better off." In effect, the government can buy workers' support.

Consumers are the voice of the unknown. Consumers don't have a voice unless you do something about it. In figure 5, it can be seen that too many times the bars are on the left side. In these cases, consumers

actually ended up as losers. As they are diffused and not organized, they can not oppose government policy. It looks as if they can be taken for a ride. It looks as though the buyers can benefit, the treasury can benefit, workers can benefit, but consumers are forgotten. I think you can avoid that by regulation, as in Chile for instance. One of the most remarkable things about Chile is that they regulated their public enterprises as if they were privately owned. It was six or seven years before they privatized telecom or electricity, unlike Argentina where at the time they were selling Entel Argentina they were also setting up the regulatory regime. It was a funny arrangement because the buyers of Entel told the Government it was willing to pay a high price to take over the company as it was. The treasury wanted the money, so telecom services were not regulated in the market at the start and the consumers were the people who suffered. As a politician one might say: "It doesn't matter because who are the consumers? They will not vote for me or against me because of telephone services". But cumulatively this can erode political support, so it is politically wise to establish a regulatory regime and introduce competition before privatizing.

To conclude, the lessons of looking at the winners and losers across these countries and across these cases, the important actors include the government, buyers, workers and consumers. For the government, open bidding is the best strategy. Have as many bidders for your enterprise as you possibly can. That

is the only way to maximize returns to the treasury. Do not give special concessions. Do not worry about buyers from the point of view of whether they will make money because, believe it or not, they are going to make money unless the world changes so much that they miscalculate. Buyers hedge their bets. They make sure they are going to make money. A related issue that has become very important is the question of credible commitment. Can you really promise the buyer of (say) Jamaica Telecom that you are not going to change your mind later about the regulatory regime. Telecom is an asset-specific activity. The investor invests today to recover his money over a long period of time. If things turn sour, the investor can not quit because he is stuck in the country. It is not like investing in a portfolio investment from which you can just quit. Therefore credible commitment on pricing and other entry policies and interconnections is very important. If investors are not convinced that the government is going to keep its word, they are going to require more than 17% rate of return on net worth. So if a government can make credible promises, it can reduce the burden on the country. Workers can be compensated and, in fact, workers are the easiest to deal with when you think about it. Lastly, the consumers can lose a great deal if there is no regulatory regime.

To summarize so far, I described two possible approaches: One is bluffing and it does not work. The second is looking at the experience of another country and selling your programme not by doing analysis yourself but by saying: "Look at Malaysia. They have done it that way and it worked out. I can do it that way and protect you". This second approach can only achieve partial success and I will tell you why. Every single country I visited on World Bank missions would tell me "my country is different, my circumstances are different". Egypt has pyramids and Mexico has something else, etc. So no matter how much you try get support from domestic actors, they would always say no and they may not believe you in the first place. Secondly, almost every time a country is privatizing it never just privatizes. It is always doing several other things. So when you tell them about (say) Chile, they tell you to look at what they are doing. "We are doing something else, we are introducing competition, we are regulating, so I am not accepting what you have told me about other countries. First, they are different from me, second

we are doing a lot of other things besides privatization".

D. Ex ante stakeholder analysis

I am going to suggest to this group that it is really time that we go for what I call ex-ante analysis of stakeholders. Why is it that every time we plan a new plant, whether steel plant, cement plant, or electricity plant, we do a project appraisal? We calculate internal rate of return and economic return and we are so sophisticated about it. We have shadow pricing and financial pricing and we do it routinely for projects of \$100 million. Then we come to privatization projects which in some cases are about billions of dollars. Transferring a big chunk of assets from one actor to another is like an investment decision but we do not do the equivalent of investment project appraisal. Why? Why do we not do that even though it is very important and you want to sell your privatization especially of telecom and power? You want to sell it to an audience that is sceptical. No-one worries about selling a chocolate factory because there is a lot of competition, but I would be very worried about selling a telecom because it is a monopoly. I don't know what the new owners are going to do with my consumers. So opposition will mount with respect to this very large project. Why is it that we do not do the ex-ante analysis to identify the potential gains and losses, identify the potential winners and losers, and devise policies to redistribute the benefits and losses in such a way as to convince people that this is the best way of proceeding?

I have just done an exercise on Telecom Egypt. This was not an imaginary exercise but a real exercise and I am going to report the result to you. If you look at the profitability of Telecom Egypt, their profit over net worth, or public profit or quasi-rent over revalued assets, the numbers are actually very good. The company is doing very well. They were making an average 14 per cent return on net worth between 1986/87 and 1995/96. The company is also improving productivity, both labour productivity and total factor productivity. So policy makers would tell me in Egypt that there is not really a strong case for privatizing. The case begins to materialize when you compare Egypt with other countries, the countries that have reformed their telecoms, such as Argentina,

Chile, Jamaica, Malaysia, Mexico, The Philippines, and Venezuela. On almost every performance indicator, Egypt Telecom has been doing less well than these countries that reformed their telecoms (see

table 1).

Table 1. International Comparison of Telecom Performance (1994)

Indicator	Egypt	Argentina	Chile	Jamaica	Malaysia	Mexico	The Philippines	Venezuela
Service availability								
Telephones/100 inhabitants	3.9	14.1	11.0	8.6	14.7	8.0	1.7	10.9
Waiting time (years)	5.8	0.9	1.2	4.3	0.3	0.2	5.5	3.7
Satisfied demand (%)	65.0	90.7	88.6	59.6	95.9	97.7	56.7	71.8
Efficiency indicators								
Lines per worker	45	155	153	59	97	174	55	119
Revenue per line (US\$/year)	322	1023	775	1067	598	1019	759	445

Source: Ahmed Galal (1997) Telecom Egypt: Status and Prospects Working Paper No. 23, Egypt Centre for Economic Studies, Cairo.

So you begin to tell policy makers: "I know you are doing very well, but you can do even better. These are the countries that did reform". Then he asks what should be done and who will be the winners and losers? The answer is that Egypt Telecom is not doing as well compared with these countries that did reform because of lack of competition or threat of competition. By law, Egypt Telecom is the only company in town that can do anything that has to do with telecom of any kind. So consumers wait for five years for a telephone. "When we have the money we will get you new phones and you have to wait". The other hindrance to efficient operation and consumption is that the price structure is really messed up. For instance, Egypt Telecom does not pay taxes but it is subsidizing the metro, so the company sells local telephone services at very low prices, while overcharging international users. When I was in Egypt I remember having to pay something like \$2.50 per minute, though when I called from Washington it was about 80 cents a minute. So the local people stay on the phone all the time chatting about everything, consuming local services unnecessarily, and the people who need to make international long distance calls consume less,

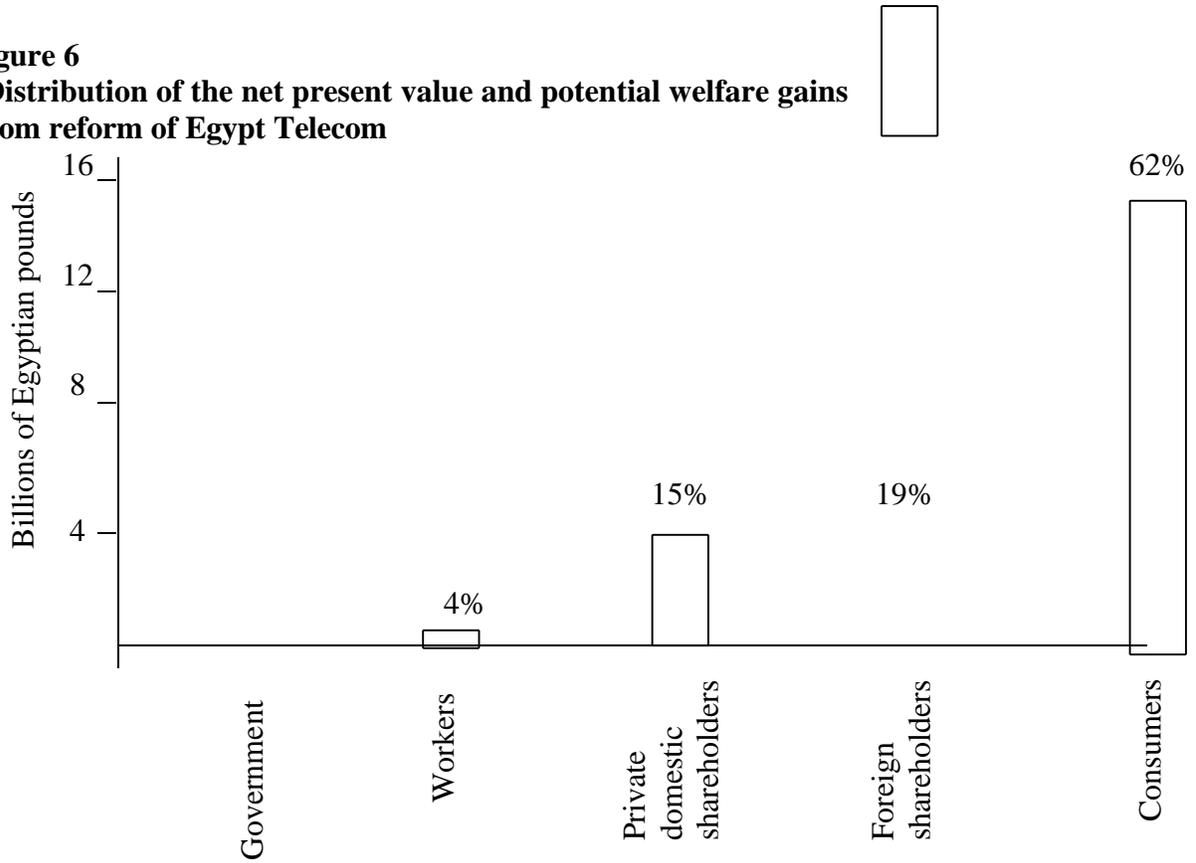
causing inefficiency in consumption. There is also of course inefficiency in production.

As Egypt Telecom is owned by the Government, it is also the company that regulates the market. So it is not only the operating company, it is also the regulating company. The whole sector was combined in one entity which is Egypt Telecom. That situation was the same in other countries before reform. So if I want to change that situation, how do I calculate the winners and losers? I need to do a few things. One is to identify the changes that will follow the bundle of reforms, not just privatization but the reform bundle. If the Government privatizes, if it regulates, if it introduces competition and if it does all these reforms, I need to identify the outcomes. Secondly, I need to model that change. I need to project the factual and counterfactual over a period of time into the future. And then I need to estimate the impact at the end of the day. I did all that and the results are very interesting. Remember that these results are all in the future so they have not happened yet. These results are based on assumptions which are very explicit. The results should make everybody happy (see figure 6). The consumers would get high returns. The foreign shareholders would also gain, assuming

that they are buying a portion of the shares. So also
would the private domestic shareholders and the

workers. I made the Government break even.

Figure 6
. Distribution of the net present value and potential welfare gains from reform of Egypt Telecom



Source: Ahmed Galal (1997) Telecom Egypt: Status and Prospects Working Paper No. 23, Egypt Centre for Economic Studies, Cairo.

By means of this model, one can identify what I call the floor price and one can identify the maximum price. The floor price is the price at which the government does not gain or lose. It is the present value of all the future cash flows to and from the company, based on what the government gets now and what it is likely to get if it continues that way into the future. Whether the government gets this value now or over a period of time does not really matter. We also identify the ceiling price or the maximum price. This is the discounted present value of all the benefits that the shareholders can squeeze out of the company over a long period of time. This sets the maximum price the shareholders would be willing to pay. The buyer says in effect: I want to take this company, I am going to introduce new products, I am going to introduce new markets, I am going to change its technology, and that will generate returns which, after discounting, have a present value of (say) 150. The government could get 100 and I can get 150 out of it because I can work on it a little harder. The actual price is always somewhere in between these two valuations and it depends on how the government bargains. The worst case scenario is that government would break even and agree a price of 100. But the best case scenario, if you have a number of bidders, each of them knowing the same facts, is that they would bid the price up a bit and you finish with a price somewhere about 125.

In any case, the numbers are not important here. What is important is that the government can design its policies before the event so as to affect different actors in the way that they like. They can regulate the prices.

If they want, they can rebalance prices so as to end the subsidization of local calls and reduce the overcharging on long distance and international calls. This happens in every reform of telecoms, either in the short term or the long term. Overall, government can design policies to benefit who they want. This is why this is the best approach politically.

In conclusion, the political economy of privatization is really about winners and losers. Secondly, bluffing

does not work: it comes back to haunt you later. You can benefit from the experience of other countries, but ex ante analysis is best. Remarkable results can be achieved, especially with large projects like telecoms and electricity.

VI. MOBILIZATION OF SUPPORT FOR PRIVATIZATION

A. Introduction

Traditionally, governments have always owned and operated railways, water, electricity, telephones and postal services. These were deemed to be “natural” monopolies subject to benefits of scale. As most developing countries gained independence in the fifties, their governments increased their participation in the production and distribution activities of their economies ostensibly to promote faster growth and development. This gave rise to public enterprises which, in many countries, played a very significant role in terms of investment, production and employment.

Up until the end of the 1970s, academic and policy debate centred mostly on improving performance of public enterprises. Public ownership was not seriously questioned. It was the Reaganite and Thatcherite revolutions in The United States and The United Kingdom and extensive privatization in The United Kingdom and Chile that dramatically altered perceptions of public ownership. A strong case was made for privatization of State-owned enterprises in developing countries and for greater reliance on competitive market forces for efficient allocation of resources. It is argued that privatization in a competitive market structure will not only improve efficiency in resource allocation but may also release resources through elimination of subsidies, waste and corruption prevalent in public enterprises – which could further contribute to growth.

Developing countries observed the lessons from the privatization experiences in Chile and The United Kingdom and continue to learn from on-going experiments in privatization. One of the important lessons, they recognize, is that public support is crucial for its success. And yet very few of them have made any conscious and concerted efforts to mobilize and sustain public support for privatization. Few have any institutional and policy arrangements in place to mobilize support. The approach in most cases has been an ad hoc one, dealing with a situation as it arises. It is reactive instead of being proactive. Also, it is not always

consistent. This reminds one of the rhetoric on popular participation in development planning in the fifties and sixties. Most development plans advocated popular participation but few governments ever had any coherent and consistent policies to enlist it.

Solid public support for privatization has many advantages. It smoothen the process of privatization by having fewer battles to fight and especially not the unexpected ones. To that extent, it lends some degree of certainty to the process. Public support helps to build a consensus on the broad policy objectives of privatization and enables the formulation of remedial measures, especially for displaced labour, without disrupting the privatization process. It also enables a focus on technical issues such as methods of privatization, valuation and pricing, financing, marketing, regulation, etc. With public support it becomes easier to aim at some social objectives, eg. wider distribution of ownership of privatized assets. Finally, public support also helps to initiate other reforms – sound macroeconomic and structural policies – to foster

competition and improve overall efficiency. Of course, public support alone cannot guarantee 100 percent success in privatization, but without it privatization will flounder.

Public support is needed throughout the entire process of privatization and even beyond during the phase of assessment and evaluation. The initial phase consists of preparing a suitable environment for privatization; institutional arrangements, defining goals and objectives, overall strategy and policies, etc. Then comes the identification of enterprises, choice of methods of privatization, valuation, pricing and marketing, and evaluation of implementation. Obviously, all these phases form a composite task. Public support is needed at each stage. Mobilizing support is not a one-shot affair but a continuous process. Gains accrued in this process at one stage may not always be permanent. Public attitudes and perceptions may shift over time depending on how gains and losses from progress

in privatization are perceived. Sustaining support, therefore, calls for constant vigilance and readiness to take corrective and timely action.

Sometimes, meeting the pre-conditions for privatization is construed as sufficient for mobilizing support. This is likely to influence public opinion favourably. However, it would be incorrect to suggest that meeting pre-conditions alone will generate public support, since pre-conditions deal substantially with the macro-economic environment and the design and strategy of privatization, while public support relates mainly to the acceptance by the public of privatization in terms of its economic and social implications and impact.

The factor of acceptance, described in this sense, is most important on the domestic front. The level of intentional support or response on the other hand depends very much on commercial considerations and on the efficiency, speed and fairness in the implementation of privatization. In view of these differences in perception between citizens and external parties, obviously different issues arise in mobilizing support at the national level and at the international level.

In privatizing State-owned enterprises, governments are likely to encounter resistance on the domestic front from different sources and for different reasons. It is essential to develop appropriate policy responses to minimize or overcome such resistance. But it is not sufficient merely to respond to critics. Governments should undertake active measures to inform and educate all sections of population on all issues in privatization.

B. Domestic support

1. Overcoming obstacles

There is no single criterion on which to evaluate the merits of privatization. Economists are inclined to think in terms of gains in efficiency in the allocation of resources. But other groups in society may have different expectations and perceptions.⁵¹ Since a single criterion cannot accommodate different expectations, governments may, therefore, encounter obstacles or opposition from different sources and for different reasons. One has to address all the major issues originating from different groups to mobilize public support.

Ideological obstacles

Ideological obstacles to privatization come mainly from “leftist” or “socialist” politicians and intellectuals. This, of course, assumes that such politicians and their parties are in a minority. In many countries, these groups still believe in a major role for the State in the production and distribution processes of the economy and in the ownership of productive assets in the critical areas (commanding heights) of the economy. Their support for strong State intervention, especially on the grounds of structural conditions prevailing in developing countries, has been well documented over the years. They view privatization as a “retreat of the State” and paint the political party in power as being “pro-business”. The role of the leftist parties, though their size is in decline, is quite influential in many developing countries.

In the past, these groups have opposed privatization in some countries; for example, in Mexico and Sri Lanka. In the early days of privatization in Mexico, there was strong opposition from the leftist parties and trade unions affiliated with them. The government tried to contain the criticism by using the term “disincorporation” instead of privatization.⁵² In Sri Lanka, the communist party had opposed privatization by saying that the government was attempting “to sell off people’s assets” to capitalists at throw-away prices. They also threatened to renationalize bus transport and insurance when they came to power.⁵³

A conservative party in power may not have much success in persuading an opposition party which is at the other end of the political spectrum. Some “centrist” parties or those known recently as “centre-left” may have greater success. But there are other ways of dealing with this situation. In the first place, governments must make concerted efforts to explain fully to the people that privatization is not a “retreat of the State” nor its shrinkage. Even after

⁵¹ See Contribution by Yair Aharoni (Essay 4) in Ravi Ramamuti and Raymond Vernon (Ed): *Privatization and Control of State-Owned Enterprises*. Economic Development Institute-Development Studies. The World Bank, Washington, D.C. 1991

⁵² See William Glade (Ed): *Privatization of Public Enterprises in Latin America*. 1CEG. 1991 P.10

⁵³ See A.S. Jayawardena: Privatization in Sri Lanka in V.V. Ramanadham (Ed): *Privatization in Developing Countries*, Routledge, 1989.

privatization of non-core enterprises, governments of developing countries would still have a vast potential for action. In infrastructure, education, health and other social services, there is enormous scope for State intervention. If governments could only raise additional resources and improve productivity of current levels of expenditure in these areas, they could make significant contribution not only to growth but also to increases in welfare especially of the poorer sections of society which are usually courted by leftist political parties. Moreover, governments also have responsibility for sound macro-economic management and for orderly functioning of all markets. This requires an increase in surveillance and regulatory activities. With expanding economies, these responsibilities will increase substantially. In most developing countries, debate on such issues is usually confined to the urban elite. It does not extend to the countryside. Governments must, therefore, make special efforts to reach vulnerable groups and explain the nature and scope of its present and future role.

Another approach to countering ideological opposition is to demonstrate success in the early stages of privatization. This can be done by not being too ambitious and without rushing too much.⁵⁴ For example, discontent with overly ambitious and fast-track privatization in The Russian Federation seems to have led to lack of support for economic reforms. Privatization of profitable enterprises which already operate in a competitive market could be a useful start.

Finally, governments can aim at widespread ownership of privatized assets and promote involvement of small investors as Chile did in her privatization program through, *inter alia*, limitations on individual shareholdings, concessionary credit, etc. All such measures should help to minimize the impact of ideological opposition and mobilize greater support for privatization.

Vested interests

There are some vested interests, fairly familiar by now, which are likely to oppose privatization. Major interests are government and public enterprise bureaucrats, public sector trade unions, big suppliers to public enterprises, and politicians in public sector locations.

The bureaucrats are inclined to oppose because they fear losing their power base, perks and prestige. Large suppliers to public enterprises have their business interests and often prefer rent-seeking activities to doing business in open competitive markets. Politicians in public enterprise locations have their narrow interest especially in safeguarding employment of workers in their constituencies. Though individually these are small groups, they are capable of forming alliances with each other and with political parties opposed to privatization. Both Argentina and Chile encountered such opposition. The resistance from these groups can be overcome by strong and committed political leadership and also by nourishing pro-privatization business groups in the private sector.

Public sector trade unions

The most common problem, encountered by practically all countries implementing privatization, is the opposition from public sector trade unions. Their main fear is lay-offs resulting from privatization. Their resistance is rooted in anxiety about "economic environment bereft of job opportunities, adequate unemployment compensation, retraining, job counselling and placement assistance"⁵⁵ These fears are intensified in economies that remain somewhat stagnant or are not growing rapidly to provide increasing opportunities for employment. And not only opponents of privatization support workers' resistance but even politicians in power are usually shy of confronting the public sector unions. There are several instances in which implementation of privatization was considerably delayed

⁵⁴ John Heath: Privatization: modalities and strategy in V.V. Ramanadham, *Ibid*.

⁵⁵ William Glade (Ed), *Op. cit.* p.122

because of government's indecisiveness in coming up with a satisfactory solution for retrenched workers. Governments must face this issue squarely and fairly. It should have a constructive dialogue with the trade unions and bring to bear the experience of other countries in this matter. Trade union leaders can also be encouraged to study experience in other countries. For example, in the Philippines trade union leaders were sent to Argentina to study that country's experience.

Mobilizing workers' support for privatization is very essential. Various approaches have been suggested and tried to achieve this objective. A least satisfactory approach is to pass over the problem of retrenchment to the buyer in the private sector. To cushion the impact, some governments make deferred retrenchment (eg. after 3-4 years) a condition of sale. The prospective buyers, of course, extract a price—lower prices for assets of public enterprises—from governments for assuming such an unpopular task. Labour unions usually come to know of such arrangements and have resisted them. They have stressed their right to know of workers' employment status at the time of privatization.

A second approach, tried in recent years, is to set up a fund— a safety net—to provide compensation and retraining to workers retrenched in privatization. Very little experience has been gained in the use of this approach and so it is rather premature to evaluate its success. Some criticism which has surfaced points to bureaucratic corruption, inadequate criteria for compensation, and incomplete conceptualization of retraining. This approach also does not seem to provide for job counselling and placement assistance. However, it has real merits and should be pursued seriously. To be effective, the safety net should provide severance pay and facilities for retraining, placement and job counselling.

A third approach, usually mentioned in the literature, is to provide severance pay and cash vouchers to displaced workers. Cash vouchers are used by workers in finding alternative employment. They are given to prospective employers. Cash vouchers would thus constitute an inducement and a wage subsidy to prospective employers. The voucher can also be considered as a lump-sum payment for retraining of workers. Such vouchers have to be tailored to individual skills of workers and some guarantee has to be obtained about the minimum duration of employment. This voucher scheme is likely to raise administrative difficulties especially in monitoring the correct use of vouchers.

So far the most successful experiment seems to be the one undertaken in Chile. The Government of Chile actively encouraged the participation of workers and small investors in the privatization process through " popular capitalism". This was done by sponsoring employee stock ownership programmes, providing concessionary credit facilities, and by placing limitations on individual shareholdings. Workers in privatized enterprises were given advance severance pay and were

sometimes offered shares at lower prices.⁵⁶ Mexico also expressed willingness to transfer some public enterprises to "social enterprises" owned and operated by workers.⁵⁷ Thus, worker participation in the ownership and management of divested public enterprises can be a very useful tool to mobilize their support. There may, however, be a difficulty with this approach. It is probably easier to elicit workers' participation without compromising on the quality of corporate governance where the SOE to be divested is skilled labour-intensive eg. computers, electronics, etc. Practical difficulties may arise, especially with regard to participation in management, when a large pool of unskilled labour is involved. In such cases, one might consider offering a block of shares to the relevant trade union which could then apportion them and the benefits among workers. Institutionally, it would then be the trade union which would own the shares and participate in management.

Technical reservations

There are several enterprise-specific technical considerations in the implementation of privatization which determine long-run support for privatization. Methods of privatization, pricing and marketing of assets, identification of competent buyers, concessions given to buyers, design and effectiveness of regulatory authorities and the like are important technical issues which, if handled successfully, will contribute greatly to mobilizing public support.

There is, however, a general technical issue which might call for greater efforts to mobilize support for privatization. A small but influential group of economists and public policy experts genuinely argue on technical—not ideological—grounds that ownership per se is not a determinant of efficiency and hence changes in ownership alone may not bring about gains in efficiency. Available empirical evidence, they point out, does not conclusively support the view that private sector is necessarily more efficient than public sector. There are examples of loss-making and profit making enterprises in both sectors. A private monopoly is just as bad as a public monopoly. There is general agreement that efficiency is more a function of competition than of ownership. This opens up another policy track. Is it possible to improve efficiency by subjecting public enterprises to market forces rather than privatization.⁵⁸ This line of reasoning gains considerable support especially in view of the fact that many privatization programmes have not resulted in increased competition. People have perceived privatization programmes as old wine in new bottles. A simple lesson to be drawn

⁵⁶ For a detailed discussion see D. Mechetti and R. Luders: *Privatization in Chile*, ICEG, 1993

⁵⁷ William Glade op. cit. p.127

⁵⁸ See United Nations: *Role and Extent of Competition in Improving Performance of Public Enterprises*, New York, 1989

is to improve market structures before privatization and in the meantime to privatize only those public enterprises which have been already working under competitive market forces. Effective regulatory apparatus must be in place when a SOE is privatized in a non-competitive market. Without these reforms, public support is likely to wane for privatization.

2. *Active measures to mobilize support*

Transparency and honesty are most essential conditions for successful privatization. Without them, the public will not have the facts and is likely to become more sceptical. There are some matters which are probably most important to the general public. First, the public would like the privatization process to be completely free of corruption. Second, the public wants to be reasonably assured that the public enterprises built with taxpayers' money are not being sold below their fair market value. Finally, it wants to be assured that the buyer is a competent entrepreneur. In mobilizing public support, a government has to combine transparency with communication and inform and educate the public on all aspects of privatization.

Institutional arrangements

As a first step, governments must create institutional arrangements for mobilizing support. Such an agency or unit should have strong political support because it would need cooperation from public enterprises and officials in charge of privatization policies and implementation. It should also have competent staff especially skilled in communication. The general functions of such a body should be, *inter alia*, to prepare factual and analytical material on all aspects of privatization, launch campaigns to inform and educate the public, serve as a storehouse of knowledge and information, and undertake ex-post evaluation of privatization in relation to its stated objectives. Such a unit should also provide complete information to foreign investors

Consumer support

Consumers also expect privatization to result in efficiency gains. The efficiency gains must translate themselves into gains in consumer welfare which will be perceived as better product quality at the same price or lower price for the same product quality. It is, however, possible that in the short run the price of a product which was subsidized before privatization may actually increase because of withdrawal of the subsidy. The buyer(s) may need some time to undertake a cost-minimization programme. But if such plans or information is made public, consumers may continue to support privatization. Consumers may also attach importance to the indirect effects of privatization. For example, if governments use proceeds from privatization to pay off part of the public debt so as to reduce future interest payments and fiscal deficits, this could result in lower interest rates which may boost consumer spending on durables. So in the final analysis, consumer support will depend on measures taken by governments to bring about gains in consumer welfare.

A.External support

Most developing countries need external support in technical and financial areas because they may not have enough skilled personnel to handle all technical aspects of privatization and their financial markets may be small and too narrow to absorb large-scale privatization.

Technical support

Technical support can be mobilized from multilateral and bilateral aid agencies. Among the multilateral agencies, the World Bank and UNDP have been quite active in this field. Regional development banks also provide considerable support.

Most of these agencies provide technical support for the design and strategy of privatization, restructuring of enterprises, asset valuation, assistance in the setting up of regulatory institutions, and on other aspects of privatization. Some of this support comes free while some may be provided in the form of soft-loans.

Financial support

Countries would need external financial support of two types: (i) to set up safety nets for compensation and other assistance to displaced workers, and (ii) direct private foreign investment in privatized SOEs.

Governments should not hesitate to seek financial assistance from abroad to finance their safety nets. Labour support, which is crucial in privatization, will be forthcoming if displaced employees are treated fairly and justly.

Privatization need not be slowed down or postponed for want of buyers at home. Governments should actively encourage private foreign investors to invest in privatized SOEs. They should, therefore, establish appropriate policy environment to attract foreign investors. Important issues in this field are the extent of equity participation, guarantees against renationalization, reasonable stability of currency, repatriation of profits, labour policy, etc. Fears of dominance by foreign investors are sometimes exaggerated. A sound regulatory framework should protect national as well as foreign investors' interests.

B. Conclusions

Domestic and external support are essential for the success of privatization. The extent and duration of support will depend on the ability of a government to demonstrate clearly the net gains from privatization. As different groups in a society will have different interests and expectations, governments will have to adopt different methods to mobilize support from various groups. Mobilizing is a two-fold task. It entails overcoming or responding to the resistance from certain sources on the one hand and taking appropriate measures to mobilize support for privatization from all groups on the other hand.

Perhaps the most essential and common elements in a support mobilization strategy are transparency, fairness, and equity in the process of implementation. In other words, execution should at least be beyond reproach. These characteristics, in themselves, will command large support.

At the domestic level, greater attention needs to be paid to support from labour and consumers. Labour policy has to be an essential element of a privatization strategy and should be in place before selecting individual SOEs for privatization. Fair and just severance pay and financial assistance and counselling for retraining and placement of displaced workers must be part of a labour policy.

It is very important to resist the temptation of an ad hoc approach. Mobilizing support is a continuing process in which efforts have to be made to explain to the public the overall and enterprise-specific objectives and strategies, their intended effects, remedial measures and long-run measures to sustain gains from privatization. Institutional arrangements for mobilizing public support are, therefore, most essential. Such a unit, staffed with specialists in communication, should engage in a continuous process of informing and educating the public on all aspects of privatization.

Consumer support will depend on their perception of economic gains from privatization. In the past, most privatization efforts have been debt-driven and few governments have done it for efficiency reasons or as part of restructuring their economies. Critics have likened it to selling jewels from the treasure box. So in the first place, the emphasis should be on improving market structures and privatizing SOEs that can operate in a competitive environment. In monopolistic situations, an effective regulatory framework is extremely important. Consumers are likely to react positively to appropriate measures in these areas and to lend sustained support to privatization.

External support—technical and financial—is very important and needs to be actively sought. Seeking multilateral financial and technical support, especially for setting up safety nets for displaced workers, should be accorded priority. Sound macroeconomic policies and a friendly foreign investment regime will attract private foreign investment in privatization.

VII. PRIVATIZATION, SOCIAL IMPACT
AND SOCIAL SAFETY NETS

A. Introduction

The economic programmes supported by the International Monetary Fund seek to improve the viability of the balance of payments over the medium run, create conditions for growth in a stable macroeconomic environment, and prevent excessive growth in external debt (Tanzi, 1989). In pursuit of these objectives, IMF-supported programmes employ a range of macroeconomic policies (e.g. fiscal and monetary policies). In addition, macroeconomic policies that promote economic stability are complemented by structural reforms that: (1) improve the quality of adjustment; (2) improve resource allocation, by providing incentives for competition and private initiative; and thereby (3) removing constraints to the growth process, and thus reinforcing macroeconomic adjustment. State enterprises, especially in developing countries, tend to be overstaffed, to pay excessive wages, and to have low productivity (Kikeri, 1998).

Consequently, these enterprises are often a drain on fiscal resources (with implications for fiscal and monetary policy) and a drag on economic growth (with implications for structural policies). Privatization of state enterprises is one of the many structural policies found in IMF-supported adjustment programmes.¹ Other structural policies include tax reforms, changes in tax administration, price liberalization, financial reforms, and trade liberalization.

¹ Privatisation involves many complex issues, and much of the technical analysis incorporated in IMF-supported programmes is typically undertaken by other organizations, such as the World Bank, regional development banks, as well as bilateral donors.

The broader context of the IMF's policy advice also entails increasing recognition of the link between economic and social issues.² Experience has shown the importance of protecting the vulnerable through cost-effective, sustainable social safety nets and maintaining the access of these groups to basic public services (Gupta and others, 1998)³

Social safety nets are broadly defined as those instruments aimed at mitigating the possible adverse effects of reform measures on the poor and other vulnerable groups. These instruments include new social safety net arrangements, such as targeted public works programmes and targeted subsidies, as well as existing social protection arrangements adapted for the purpose of short-term social protection.⁴ In designing social safety nets, it is necessary to consider the composition of poor groups, the potential effects of policy-reform measures, and financial and administrative constraints. The IMF has given advice, at varying levels of detail, on the integration of social safety nets into reform programmes.⁵ Most recently, social safety net measures have figured prominently in the IMF-supported programmes in Indonesia, Korea, and Thailand (Gupta and others, 1998).⁶

This paper discusses the potential social impact of privatization and reviews the policy responses available to mitigate the negative effects. The paper is organized as follows. Section B discusses the social impact of privatization. Section C discusses the fiscal implications. Section D reviews the various approaches to privatization and the expected social and fiscal impact of each method. Section E provides an overview of policymakers' options for alleviating the social impact of privatization through social safety nets and other measures. Section F discusses some experiences under IMF-supported programmes. Section G presents the concluding remarks.

² See Chu and Gupta(1998) for a survey of issues and experiences with social safety nets.

³ As a general principle, adjustment programmes should where possible, be designed to minimize negative social effects. Therefore, it is important to explore alternative policy mixes and assess their social implications. Typically, however, adverse effects cannot be removed entirely; therefore, special temporary social safety net measures are needed.

⁴ These transitory social safety nets need to be distinguished from permanent social security programmes, which address a number of normal contingencies, such as old age, unemployment in normal circumstances, and sickness.

⁵ As with privatisation, given the IMF's essentially macroeconomic mandate, the IMF's work in the social sector has relied on other organizations for much of the analysis, particularly on the World Bank and the regional development banks, the FAO, ILO, UNDP, and UNICEF, as well as bilateral donors and nongovernmental organizations.

⁶ In Indonesia, subsidies for food, fuel, electricity, medicine, and other essential items and the scope of employment-generating public works programmes targeted to poor households have been expanded. This measure has been accompanied by increased budget allocations for school lunch programmes, scholarships, and block grants to schools. In Korea, the emphasis of social safety net measures has been on expanding the coverage of the unemployment insurance system. In Thailand, temporary labour-intensive civil works programmes have been introduced and government subsidies for urban bus and rail fares maintained to protect urban low-income workers. The budgetary costs of the social safety net measures included in the IMF-supported programmes in 1998 ranged from 2 per cent of GDP in Korea to 6 per cent of GDP in Indonesia.

B. Social impact of privatization

Assessing the social impact of privatization is not always straightforward. A downsizing of the workforce is only one potential effect of privatization. There may also be social implications for other sectors. In any case, care should be taken to separate the impact of privatization from that of other policy changes that occur at the same time. The effects of privatization on workers, consumers, and income distribution are discussed below.

Labour adjustments

Privatization can lead to a reduction in an enterprise's workforce. It can also affect salary levels and structure, and employees' benefits.

Employment

Policymakers (and workers) often fear that employment will fall when privatization occurs, since the new owners will have to reduce the overstaffing that typically exists, to achieve higher productivity. In Sri Lanka, privatization led to 22,738 transport workers being laid off over the period 1981-1991, while in Bangladesh, the transfer of the jute enterprises to the private sector led to the loss of one-third of the managerial and clerical jobs and 7 per cent of the manual jobs (UNCTAD, 1995). The impact of privatization on the labour force, however, is not straightforward. There are several factors to consider.

First, the time frame of the analysis is important. In some instances, the adverse impact on employment may seem small, but layoffs may have been made in prior restructuring. In Chile, significant reductions in telecommunications and electricity companies were made before privatization; consequently, when divestiture took place, layoffs were limited (Kikeri, 1998). In Argentina, close to 30 per cent of the workers in five major privatizations had lost their jobs by the time privatization took place (Shaikh, 1996).⁷ Second, one has to distinguish between changes in employment at the level of the overall economy, and at the firm level. There are three possible post-privatization outcomes (see figures 1a- 1c).

For some firms, new ownership and management may lead to an increase in efficiency or an expansion of activities. In this case, the workforce may actually increase. In Chile, employment in the telecommunications and electricity companies increased by 10 per cent due to overall improvements in the economy and the companies' new investments that accompanied privatization (Hachette and Liiders, 1993). One study shows that in 10 of 12 privatized enterprises in Chile, Malaysia, Mexico and the United Kingdom, workers gained through the retention and expansion of jobs (Galal and others, 1994). In a sample of 79 firms in 21 countries, Boubakri and Cosset (1998) find that for the period 1980-1992 employment increased by 10 per cent or more for 60 per cent of the firms. Megginson, and others (1994) reach a similar conclusion for a sample of 61 companies in 18 countries for the period 1961-1990.

⁷ However, the impact of privatisation-related job losses could be overstated if the enterprises have "ghost workers".

In a study of Polish, Czech, Slovak, and Hungarian firms, it was found that as the transition progressed, the elasticity of employment with respect to sales increased (Estrin and Svejnar, 1998). Under this scenario, over the three periods—the pre-privatization period when governments can restructure, the privatization period, and the post-privatization period, say five years following privatization—the level of employment in the firm could follow a U-curve, declining during the first two periods and increasing at some point during the third (see figure 1a).⁵⁹

Other enterprises, however, may be viable in the long-run only with a permanently reduced workforce. Hence, the level of employment over time would follow an L-curve (see figure 1b). Finally, some enterprises may not be viable even under new ownership or with a reduced workforce. For these enterprises, liquidation will be the only recourse, and all the laid-off workers will have to seek jobs elsewhere (see figure 1c). In order to deal with the job losses from permanent downsizing or liquidations, privatization should be accompanied by sound macroeconomic and structural policies that promote job creation (as discussed further in section E). If these policies are successful in redeploying the laid-off workers, the positive impact on employment would be evident at the level of the overall economy, rather than at the firm level.

Third, it matters how the competitive environment and the budget constraints faced by an enterprise change when privatization occurs. If a State enterprise was already exposed to competition and faced a hard budget constraint, initial overstaffing would have been less likely and privatization would add little to the existing incentives for the enterprise to improve efficiency by, if necessary, downsizing the workforce. In Ghana, State enterprises that operated in liberalized markets underwent the same employment reductions as privatized enterprises (London Economics, 1996). If, however, privatization is accompanied by a more competitive environment and/or a hardening of budget constraints, then the adverse impact on employment is likely to be the most severe, at least in the short run. In Benin, Ghana, and Zambia, companies that retained monopoly power after privatization had few retrenchments, if any; the highest retrenchment levels were found in industries operating in highly competitive markets (London Economics, 1996). Similarly, Boubakri and Cosset (1998) find that privatized firms newly exposed to competition are more likely to reduce employment.

Salaries, working conditions, and benefits

Privatization can have an adverse impact on salary levels and structure and working conditions. Again, the time frame is an important factor: initial pay cuts may be followed by future wage increases or perhaps gains from share appreciation (if the privatization involved a degree of employee buyout or preferential allocation of shares). In the case of Malaysia's Kelang container terminal, workers benefited from higher wages. In the cases of *Teléfonos de México*, the United

⁵⁹ Employment guarantees could complicate this picture. Once the guarantee lapses, the new owner could lay off workers. In Benin and Zambia, the new owners sought to retrench workers even before the agreements had expired (London Economics, 1996)

Kingdom's National Freight Corporation, and Chile's electric company Chilgener, workers benefited substantially from share appreciation (Galal and others, 1994). Pohl and others (1997) find that, in privatized firms in Central and Eastern Europe, wage growth lagged behind productivity growth, with the difference being retained by the firms for productivity-enhancing investments. Nevertheless, real wage growth was rapid, due to substantial productivity increases.

Privatization often causes a move toward more performance-based pay schemes, more flexible working conditions (less security of tenure, increased use of non-unionized contract labour, fewer benefits, longer hours, etc.),⁶⁰ and larger wage differentials.⁶¹ In Argentina's privatized telecommunications and electricity companies, the work week increased from 35 hours to 40 hours, wages were more closely linked to productivity, and certain types of overtime and leave were eliminated (Shaikh, 1996). In Mexican telecommunications, deep-seated changes in labour relations, such as a reduction in the number of labour categories and work areas and an intensification of the work pace, were implemented in return for substantial wage increases (Botelho and Addis, 1993).

Especially in the transition economies, a related problem is the spinning off of the social assets that State enterprises use to perform social functions that in some market economies are financed through the budget. These assets include kindergartens, vacation and leisure facilities, schools, and hospitals. The transition, however, requires, that the budget should assume the responsibility for the social functions that the government wishes to finance publicly, and this transfer should occur regardless of whether the enterprises are privatized or not (Tanzi, 1993). The faster the transfers occur, the easier it will be for the enterprises to be privatized or to become economically viable while remaining in State hands. It has been pointed out that the close link between State enterprises and these social services in China has been a major hindrance in the restructuring of the State enterprises.⁶²

In summary, because State-owned enterprises are typically overstaffed and pay excessive wages, privatization tends to reduce employment and wages, at least initially. Over time, if a privatized enterprise can expand its activities and increase its efficiency, employment and wages are likely to increase. Two important determinants of how soon an enterprise moves up the U-curve are:

⁶⁰ Other possible effects of privatization on employment conditions include greater job mobility, need for retraining and skills upgrading, increased managerial discretion, marginalization of unions' influence, and tougher stance of management on worker performance and discipline (UNCTAD, 1995).

⁶¹ In the case of privatizations in Benin, Ghana, and Zambia, however, although there was indeed a move toward performance-related pay schemes for managers, these managers did not gain higher salaries after privatization. This could have been because the managerial market in Africa is not as tight as commonly assumed (London Economics, 1996).

⁶² When social assets and their accompanying expenditure responsibilities are unloaded onto local governments without a corresponding increase in revenue capacity, local budgets can experience a major imbalance between revenues and expenditures.

(1) the extent to which the competitive environment changes when privatization occurs; and (2) the presence of employment guarantees. Certain enterprises, however, may be viable only with a reduced workforce, or may not be viable at all even with restructuring. In these cases, policies that facilitate the redeployment of laid-off workers and promote employment generation are important. In the transition economies, a special aspect of privatization is the spinning off of social assets.

Price and quality adjustments

Privatization can have two contrasting effects on consumer welfare. If privatization is accompanied by an improvement in productive and allocative efficiency, then the prices of goods and services produced by the privatized enterprise should decline and their quality should improve. However, if the production of the State enterprises had been heavily subsidized, a reduction of subsidies in the context of privatization will lead to higher prices, and those groups that had benefited from subsidies will lose out.⁶³ To the extent that the subsidies had been benefiting the poor segments of the population, these price increases will have an adverse impact on their living standards.

On the other hand, artificially low prices create an imbalance between supply and demand, with implicit rationing schemes arising to bridge the gap. In some developing countries, for instance, the installation of new telephone lines, if at all available, can entail long waiting periods or bribes to technicians. Often, it is the higher-income households who have the means to get around these difficulties. Hence, although the prices charged by State enterprises may seem low, the effective access of poor households to these goods and services can in fact be limited. Privatization, by allowing prices to reach equilibrium levels, eases these supply-demand imbalances, increasing the access of poor households to previously-scarce goods and services.

Furthermore, if a public monopoly is transformed into a private monopoly, then the enterprise could exploit consumers and welfare would not improve (Vickers and Yarrow, 1991). This possibility highlights the importance of fostering an atmosphere where enterprises pursue increased efficiency, rather than revenue maximization per se. This outcome can be achieved through appropriate regulatory and supervisory mechanisms.⁶⁴

A study of 12 divestitures worldwide (Galal and others, 1994) finds that in 5 of the 12 cases, privatization resulted in losses to consumers. However, in only 3 of these cases (Teléfonos de México, Mexicana de Aviación, and Aeroméxico) were the losses substantial. In 7 of the 12

⁶³ State enterprises have also frequently engaged in cross-subsidization, reflecting the social objectives of the government. In Belarus, for example, the electricity, gas, and water companies cross-subsidized each other.

⁶⁴ In the United Kingdom, regulators have compelled the privatized utilities to achieve increases in efficiency through the "RPI minus X" framework, whereby the utilities can increase their prices by no more than the retail price inflation less a factor equal to the improvement in productivity projected by the regulator.

cases, output prices rose, while they did not change in 5 cases; but where price increases did occur, they tended to be welfare-enhancing as they brought prices close to efficiency levels. Only in two cases—British Airways and Mexicana de Aviación—did price changes modestly reduce welfare because of increased exploitation of market power.

Changes in income distribution

Privatization is often criticized for its purported negative impact on income distribution. Privatization affects income distribution through various channels.

The first channel is the shift of real assets from the State to the private sector, with potential consequences for capital income. By how much capital income is affected depends on the improvements in allocative and productive efficiencies in the enterprises as a result of privatization, and how this gain is split between the State and the new owners. If there is no improvement in efficiency and this is reflected in the sale price, the impact on capital income and income distribution should likewise be limited. In practice, though, changes in the ownership of assets have had important implications for capital income. This is linked to the fact that State-owned enterprises are sometimes underpriced⁶⁵ and therefore their sale implies a transfer of wealth from the public to the private sector. In this case, there is a redistribution of capital income from the State (and the taxpayers) to the new owners.⁶⁶

In the transition economies, "nomenklatura privatization" and other similar developments have been seen as contributing to the dramatic changes in income distribution. In 1987-88, Gini coefficients tended to be in the low 20s, which was very good by international standards. By the mid-1990s, the Gini coefficients had increased sharply in Ukraine, Russia, and the Kyrgyz Republic, reaching values seen only in few developing countries, and these coefficients have probably increased further in more recent years (Tanzi, 1999).

The second channel is labour income. The impact on labour income could change over time, as enterprises move from a period of low employment and low pay (during the reprivatization and privatization periods) to a period of increased employment and pay.

The third channel is wage differentials. These differentials are typically greater in the private than in the public sector, and privatization would therefore tend to reinforce them. Again, timing is an issue: The decompression of pay scales can be done rapidly or phased in, depending on the circumstances. Because the average earned income in the private sector is usually higher due

⁶⁵ Tanzi (1998) points out that corruption can play a major role when public officials have discretion regarding decisions on privatization and the conditions attached to that process. It is therefore important to ensure effective governance of the agencies involved in privatization.

⁶⁶ Kolodko (1998) concludes that "to properly measure inequality, one must analyze not how the flow of income is dispersed, but how it is distributed and how the stocks of denationalized assets are divided."

mainly to higher labour productivity, a shift in labour to the private sector can be expected to raise income inequality (Kolodko, 1998).

C. Fiscal implications

Direct impact

The direct effect of privatization on the budget is through the privatization proceeds. If the initial fiscal impact of privatization is positive, it can create room for additional spending on social programmes, such as the ones described in section E below. If the fiscal impact is negative, policymakers must adjust the budget by raising taxes or cutting back on expenditure. The impact depends on a number of factors.⁶⁷ In the simplest case, it is zero, because the sale price received by the government for a profitable enterprise will equal the discounted stream of profit remittances that would have been received if the enterprise had remained in the public sector. That is, privatization will only change the structure of government net wealth, but not the level. If the new owner pays a price higher than the existing discounted income stream—perhaps because of the expectation the income stream would improve after privatization—then the fiscal impact will be positive.

Some methods of privatization offer better chances of producing a positive fiscal impact than others. The risk of underpricing is probably largest in the cases of sales to strategic investors and management/worker buyouts, although the risk can be lessened if there are transparent mechanisms for establishing the sale price. Although mass privatization and restitution do not generate any sales proceeds, they can nevertheless produce a positive fiscal effect if the privatized enterprises had been a net drain on the budget.

There is also a time dimension. On one hand, the government may be financing the operations of the enterprises through subsidies, lending, and capital transfers. On the other hand, the enterprise may be contributing to government revenues through taxes, dividends, and debt service payments. After privatization, these net revenues will cease to flow into the government budget; instead, the government will receive a one-time payment in the form of sales proceeds. Fully spending the proceeds will augment government spending in this particular year but create a gap in the following years. Such a gap can be avoided if the government uses the proceeds to retire debt, thus retiring future debt service payments by an amount equivalent to the fiscal gap. Only the excess sales proceeds can be used to finance spending without burdening future budgets.

In their study, Galal and others (1994) found that in 9 of 12 cases, the fiscal impact was positive. In the case of Malaysia's Kelang container terminal, the government earned increased corporate

⁶⁷ See Mackenzie (1997); and Heller and Schiller (1989).

taxes from the enterprise and benefited from the appreciation of its retained 49 per cent share. In contrast, the Chilean treasury is estimated to have lost dividends and corporate taxes equivalent to 22 per cent of the sale price from the privatization of the electricity company Chilgener. For Teléfonos de México, the net fiscal impact was essentially zero: reductions in indirect taxes were compensated by increased corporate tax payments.

Fiscal implications of measures to address the social impact

Further down the road, privatization may have additional fiscal effects. Because governments may choose to employ social safety nets to cushion the adverse impact of privatization, the costs of these social programmes will also have to be included in an overall assessment. Public sales and auctions, for instance, are most likely to maximize the proceeds (that is, the direct fiscal impact) from divestiture. However, restructuring is also likely to be faster and deeper under this scenario.⁶⁸ The attendant social impact will also be more profound, perhaps requiring a higher level of social spending. For instance, policies to redeploy or retrain laid-off workers can entail fiscal outlays over an extended period of time after privatization.

The initial sales proceeds can help finance the attendant social measures. But if they prove insufficient, the government will either have to raise additional revenue or change the composition of spending. Ideally, the government should reduce unproductive public spending to free up resources for social safety nets.

It can be asked whether privatization proceeds should be earmarked to finance social safety nets (e.g. severance payments). Because budgetary resources are fungible, earmarking is technically unnecessary. In fact, if the proceeds are used, say, to reduce public debt and future interest payments, thereby freeing up resources for social spending, this recourse may prove more efficient than earmarking the proceeds.⁶⁹ Moreover, earmarking can make fiscal management inflexible.

D. Methods of privatization: social and fiscal impact

The method used to privatize enterprises may to some extent determine the social impact. In the short run, some methods offer more options for smoothing the restructuring process. In the long run, the choice of method is probably less important, as long-term employment levels are determined by other factors.

⁶⁸ This is discussed at more length in section D.

⁶⁹ According to Aninat (1998), prudent overall fiscal management in Chile promoted macroeconomic stability and economic growth. These achievements, in turn, increased the purchasing power of the poor, and generated additional revenues that were allocated to properly focused social spending. A concrete example is the repayment of public debt through continuous fiscal surpluses, which freed resources for redistributive spending and investment.

Sales

Public sales and auctions

Public sales and auctions are most often employed when enterprises are divested singly. Methods include initial public offerings (British Telecom), sales of shares of already corporatized or publicly traded enterprises (Philippine National Bank), or public auctions (the prevalent method for privatizing small businesses in Central and Eastern Europe).

To the extent that these transactions are transparent and efficiently conducted, the government collects maximum revenue. But to make the price worthwhile, the new owner must undertake a broad and rapid restructuring; hence, the impact on workers and consumers tends to be large under this method. Furthermore, the government has little leverage in terms of incorporating its social concerns in the sales contracts, unless such provisions are explicitly incorporated in the terms of the sale (perhaps reducing the sale price).

However, since the enterprises also benefit from getting fresh capital and, in many cases, new ideas, chances are also best for a quick move up the U-curve in terms of employment and compensation.

Negotiated sales to strategic investors

In contrast to public auctions and sales, negotiated sales enable the government to influence the divestiture to achieve its social objectives or to exclude unwanted buyers (e.g. foreign investors). However, these constraints on the new owner can lead to a lower sale price, reducing the revenues that the government can use to finance social safety nets.⁷⁰ Also, once the employment guarantees expire, the government has little leverage for protecting workers. And due to their decreased transparency, negotiated sales give rise to fiscal and distributional concerns; that is, the enterprises can be underpriced during the negotiations, causing a negative effect on the budget, as well as benefiting the favoured buyers. This risk of an adverse distributional impact via the capital income channel is greater than in the case of public sales and auctions.

Management/employee buyouts

Management/employee buyouts (MEBOs) have played a major role in a number of Eastern European countries. Under MEBOs, there is neither an infusion of fresh capital nor of new ideas. Consequently, employment, average pay, wage differentials, output structure, output prices, and productivity levels change only gradually. In the case of employment, workers are dismissed only if their wages exceed the value of their average product, rather than their marginal product, as efficiency considerations would dictate (Nuti, 1995). This approach appears to offer the

⁷⁰ One study concludes: "As a rule, conditions attached to privatizations by government detract from an enterprise's value because they increase uncertainty or restrain privatized firms' commercial freedom of action (Welch and Frémond, 1998).

greatest chance of minimizing the adverse impact on employment; however, it also means that the benefits of privatization are delayed.

Management or lease contracts

Under management or lease contracts, the government retains ownership but delegates the management functions. Thus, there is no transfer of assets to the private sector. Instead, private sector technology and skills are provided for an agreed time and for a fee. Under a management contract, the private company earns a fee for managing the enterprise; the government keeps the profits.⁷¹ Under a lease contract, the private company pays a rent to the government and assumes full commercial risk. Lease contracts are relatively rare in

industrialized countries, but more usual in developing countries.⁷²

The impact of these two types of contracts on the budget should be rather similar. If the private company manages the enterprise efficiently, then either contract can produce a steady stream of revenues for the government. The impact, however, could differ in terms of the workforce and consumers. Management contracts typically provide for cost-plus payments to the manager; hence, so long as the manager earns the fee, he/she would have little motivation to change the prices charged by the enterprise or the workforce. In the case of a lease contract, the lessor has an incentive to raise prices and cut the workforce, since he/she can keep all extra proceeds net of the lease payment.

Mass privatization

Mass privatization (also called voucher or coupon privatization) has been most prominently applied in the transition economies. It does not generate revenues for the government, because the shares are distributed to the population for free or for a nominal fee. There can, however, be a negative fiscal impact if profitable enterprises are divested.

Different technical methods have been applied. In The Russian Federation, the shares were distributed directly to the population. In the Czech Republic, The Russian Federation, and the Slovak Republic, the population received vouchers for shares of the privatized enterprises that could be pooled in investment funds. In Poland, the population received vouchers for shares in the investment funds, but not shares of the privatized enterprises directly. All of these methods produce, at least initially, a dispersed ownership, providing a potentially widespread distribution

⁷¹ In France, before a wave of privatizations in 1986-88, contract plans were an important feature in the state-enterprise sector. In the developing countries, the first concerted effort to implement contract plans was in Senegal in 1980-82; it was not very successful.

⁷² Lease contracts were the prevalent method used in Laos. In Jamaica, during 1981-92, one-fourth of the 32 privatizations were leasing arrangements, mostly in tourism and agriculture (UNCTAD, 1995).

of the benefits of privatization. This advantage in terms of income distribution may, however, disappear if the beneficiaries are able to resell their shares too soon: the shareholders can end up selling their stakes for a pittance (as has been observed in The Russian Federation), and not benefit from the post-privatization gains in efficiency and output.

Furthermore, if small shareholders lack the capacity to manage their portfolios or to monitor the management of the enterprises, they can lose out to better-informed or better-placed investors. To some degree, Poland's provision that individuals hold shares in investment funds mitigates this danger. The concentration of shareholdings in the funds ensures effective corporate governance, and, to the extent that the funds are well-regulated, the individuals' stakes can be protected.

Restitution

Privatization through restitution—the return of nationalized properties to their former owners—has been especially relevant in Central and Eastern Europe. Outside the transition economies, restitution has played an important role: for example, in Uganda, where the Museveni government restored the businesses confiscated in the 1970s.

Under restitution, the adverse effects on workers and consumers is likely to be as large and as rapid as in the case of public sales and auctions. Given the automaticity of the approach, the possibilities for reprivatization restructuring and for incorporating social concerns in the transfer of ownership to the private sector are quite limited. Moreover, restitution does not generate any revenues, but in the case of a loss-making enterprise, the budget no longer has to cover the losses.

E. Policy responses

The following effects of privatization appear to be particularly important for policymakers: job losses for workers, high prices for some segments of the population, underpricing of enterprises and a negative fiscal impact, and a more inequitable income distribution. Governments have a range of policy options to address these concerns.

Dealing with labour adjustment

Policymakers have four principal options for alleviating the social impact of privatization. First, the downsizing can be done in a way that minimizes the adverse impact. Second, the government can use "passive labour market policies" (such as cash grants and public works programmes) to support the displaced workers during unemployment. Third, the government can use "active labour market policies" (retraining and other programmes) to help the unemployed find new jobs. Fourth, job creation in the private labour market can be encouraged through sound macroeconomic and structural policies.

Cushioning job losses

Employment guarantees have the advantage of spreading out the downsizing over a longer period (see figures 2a and 2b). In the former East Germany, most privatization contracts contained a special clause guaranteeing employment levels for a specified period, with penalties for noncompliance. In Pakistan and Sri Lanka, employment was assured for one and two years, respectively, after privatization (UNCTAD, 1995). One potential advantage of employment guarantees is that by the time the guarantees expire, a more favourable macroeconomic environment may have emerged. The danger is that, by complicating the process of privatization and limiting the discretion of the new owners, employment guarantees can lead to lower sale prices, and it is possible that the foregone revenues could have been used more efficiently to finance safety net programmes. Furthermore, guarantees can perpetuate the existing inefficient labour practices and delay the desired gains in productivity and efficiency.

One means of providing income support to displaced workers is to provide cash support, either through severance pay (perhaps as part of early retirement or voluntary departure programmes, which are often more politically and socially acceptable than retrenchment), the preferential allocations of shares, or unemployment insurance schemes. If it is sufficiently generous, severance pay can reduce labour opposition to privatization. In Argentina, the government and donors paid an average of two years' severance payments to workers in the railway, telecommunications, and steel companies (Kikeri, 1998). Whether the government or the new owner pays severance has no material importance, because the cost is reflected in the sale price. Ultimately, the government finances the severance payment, either through the direct provision or a reduced sale price. The fiscal cost can be large. In Mali, generous severance payments—two years' pay, plus up to two years' salary to establish new businesses—led the government to halt privatization (Kikeri, 1998).

Argentina, Pakistan, Poland, Sri Lanka, and Venezuela are among the countries that have used preferential allocations of shares to employees to compensate for income losses. In The Russian

Federation, employees were entitled to 30 per cent of the liquidation proceeds. Although this recourse can enhance the political sustainability of reforms, concerns have been expressed that share allocations can lead to excessively fragmented share ownership.

Unemployment benefits can assist displaced workers only if unemployment insurance schemes already exist. In most developing countries, this is not the case. In the transition economies before the initiation of market-oriented reforms, implicit lifetime employment guarantees made such schemes superfluous. With the onset of economic transition, however, unemployment insurance schemes were introduced. For example, in Poland before 1991, nearly all unemployed were eligible for income support; consequently, 79 per cent of those registered drew benefits. In Uzbekistan in 1993, unemployment benefits were about 80 per cent of the average wage. Since then, the resulting fiscal burden has led to a tightening of eligibility requirements throughout the region (Allison and Ringold, 1996). Hence, the relevant policy choices to consider are coverage (e.g. whether to cover temporary, part-time, and daily workers), the minimum contribution period, the duration of benefits, and the level of benefits.

An alternative means of providing income support is through public works programmes, which have been successfully used, for instance, in Chile, although not necessarily in the context of privatization-related job losses. A critical decision is the level of wages. Wages should be kept below the market rate and the schemes should be only temporary, in order to keep overall costs low, target the worst-off, and encourage the participants to find “normal” jobs.

Active labour market policies

Active labour market policies are aimed at helping the unemployed return to work, thereby decreasing the duration of unemployment and increasing productivity. Policies include job counselling and job search assistance (a standard method in OECD countries), job subsidies, assistance for entrepreneurship, and retraining. When labour demand picks up, these policies ensure that there is a supply of appropriately skilled labour to meet it.

Sound macroeconomic and structural policies

Finally, private sector job creation should be encouraged. Privatization does not take place in a vacuum; it is usually one element of a larger programme of macroeconomic and structural adjustment. The more effective the programme is in fostering a dynamic private sector, the easier it will be for displaced workers to find new employment and the less the need for social safety nets. Hence, policymakers should complement privatization with macroeconomic and structural policies that are conducive to growth and private sector development. Labour market reforms that promote flexibility are especially important. Eliminating obstacles to private job creation, such as restrictions on hiring and firing and excessive payroll taxes, facilitates the restructuring process and smoothes the movement of workers to private employment.

As has been noted in section B, certain privatized enterprises may be viable only with a permanently smaller workforce, while others may never be viable at all and may have to be liquidated. The laid-off workers will have to be redeployed in other sectors. In these cases, an appropriate combination of active labour market policies and sound policies that promote employment generation will be especially important.

Mitigating the impact of price adjustments

To the extent that the poor and other vulnerable groups are affected by any price increases resulting from privatization, social safety net measures should be considered.⁷³ One option is a gradual phasing-out of subsidies to allow consumers time to adjust. Limited subsidy arrangements include food stamps and supplementary feeding programmes. Another option is to use cash transfers. In any case, social benefits should be targeted to the truly vulnerable, and should not exceed administrative capacity.

Choice of method of privatization

The policy responses discussed above are options that governments can use to mitigate the negative social impact of privatization after it has been implemented. But at the outset, there may be some scope for the government to prefer certain methods, based on the potential for mitigating the negative consequences. In some cases, however, governments may have no choice. Restitution, for instance, often depends on legal considerations and may be outside the government's discretion.

In terms of the *potential* social impact, MEBOs are most likely to maintain the status quo, whereas at the other extreme, public sales and auctions are likely to produce the largest impact in the shortest time. MEBOs can therefore be attractive to governments that wish to avoid layoffs

⁷³ See Chu and Gupta (1998) for an overview of social safety net issues and recent experience.

and cuts in compensation; however, this also delays the benefits of privatization, thereby undercutting economic reform.

Management or lease contracts are more likely than MEBOs to have an impact on employment and compensation, depending on how much discretion is given to the managers/lessors to operate the enterprises, but not as much as negotiated sales, as the ownership actually changes only after sale. Negotiated sales provide an opportunity for the government to impose conditions to mitigate the impact of privatization. There is potentially a lot of scope to fine-tune the conditions.⁷⁴ The cost, however, can be a lower sale price. Hence, the more arm's-length the method of privatization is, the less able the government will be to dictate its form. It is for this reason that public sales and auctions are the most likely of the methods available to have an adverse social impact. On the other hand, public sales offer the best potential for maximizing privatization revenues and achieving the efficiency and growth benefits of privatization.

F. Experiences under IMF-supported programmes

Following is a brief survey of some countries' experiences with privatization under IMF-supported adjustment programmes. A recent IMF study of progress under the ESAF (IMF, 1997) concludes that the implementation of public enterprise reform has been slow, uneven, and subject to extensive slippages. Furthermore, few countries have divested large enterprises in the strategic sectors.

As part of IMF-supported programmes, *Bolivia* privatized all its public enterprises (the largest of which was the petroleum company). Bolivia employed an innovative variant, called "capitalization", which mixed elements of mass privatization and public sales. Under this approach, the new owners put in capital amounting to 100 per cent of the preexisting value of the enterprise, thereby gaining 50 per cent ownership of the privatized enterprise. The remaining 50 per cent is still held by pension funds on behalf of the citizenry. An infusion of new capital and new management was thus assured, enhancing the chances that privatization would increase efficiency and output. At the same time, the citizenry could participate in the post-privatization gains, which has positive implications for the distribution of income and wealth. There was very little observed loss of employment in the privatized enterprises, but this could have been because the excess employment had been maintained in the State-retained "residual enterprises" that still performed some of the old functions of the privatized ones.

⁷⁴ For example, when Volkswagen gradually assumed ownership of the Skoda Automobile Company in the Czech Republic, it agreed to more than double production over 1990-2000.

In *Egypt*, the public sector's share of economic output and employment (about 33 per cent) has not really diminished over time (Handy and others, 1998).⁷⁵ However, since January 1996, there has been a remarkable effort to divest State enterprises: 84 companies have been divested, with a market value representing over a quarter of all non-financial enterprises. A controlling interest was sold in 80 per cent of the total (chiefly through stock market flotations and liquidation) and minority interest in the remainder. Privatization proceeds amounted to 2 per cent of GDP during the two-year stand-by agreement, which is among the best performances in emerging markets.

These enterprises were spread over several sectors (agriculture, construction, food, engineering, retail, etc.), and about 60 per cent were profitable. Despite the norm that voluntary redundancy entails a payment of three years' salary and benefits, restructuring costs were not high, due to the relatively low wage rates. The redundancy payments were financed by a share of the privatization proceeds and by funding from the Social Fund for Development (which is financed by multilateral and bilateral donors). It is interesting to note that, in 7 of the 10 enterprises sold to employees, profits improved by an average of 60 per cent after privatization. More generally, the post-privatization evidence points toward two important factors. First, the enterprises that tended to do better were the ones that had been operating in a competitive environment (e.g. through exporting) even before privatization. Second, strategic investors (especially foreign investors) are crucial in increasing efficiency.

In *Estonia*, virtually all small enterprises (1,500 in number) were divested by 1994 (mainly via auctions and open tenders, to the highest bidders for cash), and most of the large enterprises were divested by 1997 (Berengaut and others, 1998). (The next phase of privatization is divesting the remaining large enterprises, mostly in energy, telecommunications, and transportation). The large enterprises were sold based on the asking price, business plan, investment, and employment guarantees so their disposal resembled negotiated sales to strategic investors. In fact, these investors were favoured over management and employees. This focus on strategic outsiders has resulted in the infusion of new skills and an enhanced capacity for capital investment, thereby potentially hastening the movement up the U-curve. The restructuring of the enterprises has usually proceeded according to the business plans submitted during bidding. Additionally, rapid restructuring was facilitated by an effective bankruptcy law and the drying up of budget subsidies to the enterprises at the outset of transition,

In *Ghana*, prior to privatization, government subsidies to the 300 state enterprises amounted to 9 per cent of total government expenditures. In 1988, in the context of an IMF-supported programme, the government implemented a divestiture programme, which by December 1995

⁷⁵ This has also been partly due to an increase in the size of the State oil company arising from oil price increases.

had succeeded in privatizing 159 enterprises, with almost a quarter being liquidated (Ariyo and Jerome, 1999).

There were, however, several significant problems. First, local participation was very limited due to difficulties in mobilizing domestic capital. Because several successful bidders lacked the required funds, the enterprises they bought had to be retaken and redivested. Second, the fiscal cost was large (Kikeri, 1998). Redundant workers received retirement benefits (70 months of base pay, which in some cases was about 70 per cent higher than benefits in the private sector) in addition to severance payments (which were already 65 per cent higher than in the private sector). Between 1985 and 1991, termination costs grew to about 6 to 7 times Ghana's per capita GDP. On the positive side, Ghana belongs to that small group of countries that have divested large enterprises in the strategic sectors (ME, 1997).

Purchasers of assets sold through competitive tenders had full discretion regarding retrenchment. However, purchasers of shares in going concerns had to maintain the continuity of employment contracts. The available study (London Economics, 1996) on the impact of privatization on labour in Africa presents findings aggregated for Ghana, Benin, and Zambia. Yet, it is notable that, across the sample, almost 18 per cent of jobs were lost following privatization. Furthermore, many companies had already dismissed workers during prior restructuring.

In *Laos*, under a SAF and an ESAF (between 1989 and 1994), 64 of 130 State enterprises were privatized: 78 per cent were leased, 19 per cent sold outright, and 3 per cent bought in instalments (Otani and Pham, 1996). Of the 28 enterprises for which data are available, employment fell by an average of 14 per cent after privatization (however, broader labour force data suggests that the unemployment impact was minor). Job losses were more pronounced in enterprises that involved domestic investors than in those involving foreign investors. Severance payments (based on the same formula used for civil servants) were the method used to mitigate the social impact. The prevalence of fixed term leasing was seen as a drawback to new employment generation. Because ownership was unchanged, leasing may not have stimulated investment (e.g. there is no tendency for a movement up the U-curve); in fact, it could have encouraged decapitalization. Furthermore, it was unclear what responsibility the government would have for the workers once the leases had expired.

In *Poland*, direct sales of the 8,500 State enterprises was not feasible due to the lack of local capital markets and the small size of financial savings relative to the value of the enterprises (Ebrill and others, 1994). The authorities chose a multi-track approach. After 1990, State enterprises could opt for: liquidation (selling their assets to outside buyers or leasing them to insiders), capital privatization (selling shares), or remaining in the public sector. There was no

time limit for choosing a method, hence, the enterprises could temporize. By the end of 1993, 2,700 firms had been liquidated. Of this number, around half leased their assets to insiders. (After 1993, this method declined, due to a dwindling in the pool of easily leasable firms.) For the other half, which had their assets sold, completion lagged, typically due to difficulties with selling social and immobile assets. Fewer than 200 firms (typically large enterprises) opted for capital privatization (usually with a substantial share going to an outside strategic investor). However, capital privatization was the main source of budgetary revenues and was generally associated with strong improvements in enterprise performance, especially when foreign investors were involved. After 1993, another 512 firms were divested through mass privatization: all adults received shares in investment funds that held the shares in the privatized enterprises.

Unemployment rose fast during Poland's transition; however, not all of the increase can be attributed to privatization, as there had also been large changes in the macroeconomic environment. In more recent years, privatization has been occurring in the context of 5-7 per cent real GDP growth, and small and medium-sized businesses have provided robust job growth. One striking feature of Poland's experience with privatization is that disability payments were liberally granted to laid-off workers, thereby serving as an important form of hidden support. Currently, the coal sector is being restructured, and a large proportion of the miners are expected to take the generous early retirement/buyout awards.

In *Sri Lanka*, within the framework of IMF-supported programmes, 25,000 to 50,000 (depending on the data source) of 120,000 non-plantation workers were retrenched, the bulk before privatization and mostly through voluntary separation with a compensation package. Because of restrictions on firing, the compensation packages had to be offered to induce voluntary separation. Non-monetary social assistance (e.g. retraining, redeployment, and advice on how to use the compensation) was absent. In the plantation sector, no prior restructuring was undertaken: it was left to the new owners to take on the task. However, the process was impeded by the government's continuing intervention in the new managers' decisions regarding wages and production.

G. Concluding remarks

IMF-supported adjustment programmes increasingly recognize the social impact of adjustment programmes and incorporate social safety nets in policy reform packages. Privatization is one example of a structural reform that can have an adverse social impact, at least in the short run. For workers, privatization can lead to job losses, reductions in compensation, and more stringent work conditions. For consumers, it can lead to higher prices. Regarding the distribution of income and wealth, inequality can worsen, depending on the new ownership of capital assets and the split of the efficiency gains from privatization.

The method of privatization may to some extent affect its social impact. MEBOs are most likely to minimize the adverse impact, especially on workers. In contrast, public sales and auctions are likely to have a large adverse impact on workers and consumers, due to the new owners' incentive to make the bid pay off, but also maximize the government's revenue gains. One way to mitigate the negative effects of public sales is for the government to incorporate employment guarantees in the sale; it is important to note, however, that the faster and broader restructuring is, the sooner the efficiency gains can be reaped.

The above survey of experiences with privatization under IMF-supported programmes makes the following key points:

- The time frame of analysis is relevant. In the short run, to the extent that enterprises have been inefficient, job losses and wage cuts are likely under new management. However, as efficiency gains kick in, employment and compensation can be expected to recover or even exceed pre-privatization levels. For enterprises that are not viable even under new management, liquidation is the best recourse. Other enterprises may have to be permanently downsized to be viable. Those laid off under the two latter scenarios will have to be redeployed to other sectors or provided social safety nets.
- Private sector job creation is important in facilitating the adjustment. In Laos, for instance, the unemployment impact was minor, as those laid off were absorbed by the private sector. Hence, complementary labour market reforms are needed to make labour markets more flexible and reduce indirect labour costs, thereby facilitating the movement of redundant workers to other jobs. These structural policies should be complemented by macroeconomic policies that foster stability and create an environment conducive to growth.
- Severance payments have been most commonly used to mitigate the adverse impact of privatization. Employment guarantees and public works programmes have also played a role.

Unemployment benefits can help, but they should not be set too high, in order to preserve fiscal stability and to encourage the unemployed to reenter the labour market. Early retirement payments and disability benefits can be an easy short-term recourse; however, they are actuarially unsound and endanger the long-term fiscal position.

- To prevent transforming public monopolies into private monopolies, appropriate regulation of the
- privatized enterprises is critical. Regulation will help ensure that the enterprises improve the prices and quality of the goods and services they provide. Allowing market forces to determine the prices can, in some cases, improve the access of the poor to these goods and services.
- The fiscal impact matters. Some methods produce larger revenue gains for the government than others, and these gains can be used to finance social programmes during the adjustment period. In cases where the government has the

- administrative capacity to run well-targeted social safety nets, it may make sense for it to maximize its revenue gains through public sales and mitigate the resulting social impact through these programmes. However, public sales can also be expected to have the largest adverse so

- cial impact. The government's choice between incorporating social costs as a constraint on the choice of method of privatization, or using privatization proceeds to finance social safety nets would depend on its social preferences and administrative capacity, and the particular social and political circumstances.

References

Allison, Christine, and Dena Ringold (1996) **Labour Markets in Transition in Central and Eastern Europe: 1989-1995**, Technical Paper No. 352, Washington: The World Bank.

Aninat Ureta, Eduardo (1998) Addressing Equity Issues in Policymaking: Principles and Lessons from the Chilean Experience, paper prepared for the Conference on Economic Policy and Equity, Washington, D.C., June.

Ariyo, Ademola, and Afeikhena Jerome (1999) Privatization in Africa: An Appraisal," *World Development*, Vol. 27.

Berengaut, Julian, Augusto Lopez-Claros, Francoise Le Gall, Dennis Jones, Richard Stem, Ann-Margret Westin, Effie Psalida, and Pietro Garibaldi (1998) *The Baltic Countries: From Economic Stabilization to EU Accession*, IMF Occasional Paper No. 173

Washington: International Monetary Fund.

Bergeron, Ivan (1991) Privatization Through Leasing: The Togo Steel Case, in *Privatization and Control of State-Owned Enterprises*, ed. by Ravi Ramamurti and Raymond Vernon, Washington: The World Bank.

Bhaskar, V., and Mushtaq Khan (1995) Privatization and Employment: A Study of the Jute Industry in Bangladesh, in *American Economic Review*, vol, 85.

Botelho, Antonio, and Karen Addis (1993) Privatization of Telecommunications in Mexico: Its Impact on Labour and Labour Relations, IMF Occasional Paper No. 14, Geneva: International Labour Organization.

Boubakri Nargess, and Jean-Claude Cosset (1998) The Financial and Operating Performance of Newly Privatized Firms: Evidence from Developing Countries, in *Journal of Finance*, vol. 53.

Boycko, Maxim, Andrei Shleifer, and Robert W. Vishny (1996) A Theory of Privatization, in *Economic Journal*, vol. 106.

Chu, Ke-Young, and Sanjeev Gupta, eds. (1998) *Social Safety Nets: Issues and Recent Experiences*, Washington: International Monetary Fund.

Cook, Paul, and Colin Kirkpatrick (1998) Privatization, Employment and Social Protection in Developing Countries, in *Privatization, Enterprise Development and Economic Reform*, ed. by Paul Cook, Colin Kirkpatrick, and Frederick Nixon, Cheltenham, United Kingdom: Edward Elgar.

- Ebrill, Liam, Ajai Chopra, Charalambos Christofides, Paul Mylonas, Inci Otker, and Gerd Schwartz (1994) *Poland- The Path to a Market Economy*, IMF Occasional Paper No. 113, Washington: The International Monetary Fund.
- Estrin, Saul, and Jan Svejnar (1998) The Effects of Output, Ownership, and Legal Form on Employment and Wages in Central European Firms, in *Enterprise Restructuring and Unemployment in Models of Transition*, ed. by Simon Commander, Washington: The World Bank.
- Fretwell, David, and Richard Jackman (1994) Labour Markets: Unemployment, in *Labour Markets and Social Policy in Central and Eastern Europe: The Transition and Beyond*, ed. by Nicholas Barr, New York: Oxford University Press.
- Frey, Maria (1997) Employment Policies and Programmes in Hungary, in *Employment Policies and Programmes in Central and Eastern Europe*, ed. by Martin Godfrey and Peter Richards, Geneva: International Labour Organization.
- Frydman, Roman, Cheryl W. Gray, Marek Hessel, and Andrzej Rapaczynski (1997) Private Ownership and Corporate Performance: Some Lessons from Transition Economies, Policy Research Working Paper No. 1830, Washington: The World Bank.
- Galal, Ahmed, Leroy Jones, Pankaj Tandon, and Ingo Vogelsang, (1994) *Welfare Consequences of Selling Public Enterprises*, New York: Oxford University Press.
- Gifl, Indermit S. (1996) Helping Displaced Workers Find Jobs, paper presented at the Private Sector Development Seminar on Labour in Enterprise Restructuring and Privatization, Washington, D.C., June.
- Gupta, Sanjeev, Calvin McDonald, Christian Schiller, Marijn Verhoeven, Željko Bogeti č, and Gerd Schwartz (1998a) Mitigating the Social Costs of the Economic Crisis and Reform Programmes in Asia, Papers on Policy Analysis and Assessment 98/8, Washington: The International Monetary Fund.
- Gupta, Sanjeev, Benedict Clements, Calvin McDonald, Christian Schiller (1998b) *The IMF and the Poor*, IMF Pamphlet Series, No. 52, Washington: The International Monetary Fund.
- Handy, Howard, Peter Allum, Amer Bisat, James Daniel, Robert Kahn, Christopher Lane, Mauro Mecagni, Joannes Mongardini, Arvind Subramanian (1998) *Egypt: Beyond Stabilization, Toward a Dynamic Market Economy*, IMF Occasional Paper No. 163 Washington: The International Monetary Fund.
- Heller, Peter S., and Christian Schiller (1989) Fiscal Impact of Privatization, with some examples from Arab Countries, in *World Development*, vol. 17.

International Monetary Fund (1997) *The ESAF at Ten Years: Economic Adjustment and Reform in Low-Income Countries*, IMF Occasional Paper No. 156, Washington: The International Monetary Fund.

Jones, Leroy (1994) *Winners and Losers in Privatization*, in *Does Privatization Deliver? Highlights from a World Bank Conference*, ed. by Ahmed Galal and Mary Shirley, Washington: World Bank.

Kelegama, Saman (1997) *Privatization in Sri Lanka: An Overview*, in *How Does Privatization Work?* ed. by Anthony Bennett, London: Routledge.

Kikeri, Sunita (1998) *Privatization and Labour: What Happens to Workers When Governments Divest?*, Technical Paper No. 396, Washington: The World Bank.

Kolodko, Grzegorz W. (1998) *Equity Issues in Policymaking in Transition Economies*, paper prepared for the Conference on Economic Policy and Equity, Washington, D.C., June.

La Porta, Rafael, and Florencio Lopez de Silanes (1997) *The Benefits of Privatization: Evidence from Mexico*, Working Paper No. 6215, Cambridge, Massachusetts: National Bureau of Economic Research).

London Economics (1996) *The Impact of Privatisation on Labour in Africa*, report prepared for the World Bank.

Lopez de Silanes, Florencio (1997) *Determinants of Privatization Prices*, in *Quarterly Journal of Economics*, vol. 112.

Mackenzie, G.A. (1997) *The Macroeconomic Impact of Privatization*, Papers on Policy Analysis and Assessment 97/9, Washington: The International Monetary Fund.

Meggison, William L., Robert C. Nash, and Matthias Van Randenborgh (1994) *The Financial and Operating Performance of Newly Privatized Firms: An International Empirical Analysis*, in *Journal of Finance*, vol. 49.

Naqvi, Syed Nawab Haider, and A.R. Kemal (1997) *Privatization, Efficiency and Employment in Pakistan*, in *How Does Privatization Work?*, ed. by Anthony Bennett, London: Routledge.

Nuti, Domenico Mario (1995) *Employee Ownership*

in Polish Privatizations, in *Privatization Surprises in Transition Economies: Employee Ownership in Central and Eastern Europe*, ed. by Milica Uvalic and Daniel Vaughan-Whitehead, Cheltenham, United Kingdom: Edward Elgar.

Otani, Ichiro, and Chi Do Pham (1996) *The Lao People's Democratic Republic: Systemic Transformation and Adjustment*, IMF Occasional Paper No. 137, Washington: The International Monetary Fund.

Pohl, Gerhard, Robert E. Anderson, Stijn Claessens, and Simeon Djankov (1997) *Privatization and Restructuring in Central and Eastern Europe: Evidence and Policy Options*, Technical Paper No. 368, Washington: The World Bank.

Shaikh, Hafeez (1996) *Argentina Privatization Programme: A Review of Five Cases*, Washington: The World Bank.

Tanzi, Vito (1989) *Fiscal Policy, Stabilization, and Growth*, in *Fiscal Policy, Stabilization, and Growth in Developing Countries*, ed. by Mario I. Blejer and Ke-Young Chu, Washington: The International Monetary Fund.

Tanzi, Vito (1993) *The Budget Deficit in Transition: A Cautionary Note*, *IMF Staff Papers*, vol. 40.

Tanzi, Vito (1999) *Transition and the Changing Role of Government*, paper presented at the IMF Conference on A Decade of Transition: Achievements and Challenges, February 1-3.

United Nations Conference on Trade and Development (1995) *Comparative Experiences with Privatization: Policy Insights and Lessons Learned*, New York: United Nations.

Van der Hoeven, Rolph, and Gyorgy Sziraczki (1997) *Privatization and Labour Issues*, in *Lessons from Privatization: Labour Issues in Developing and Transitional Countries*, ed. by Rolph van der Hoeven and Gyorgy Sziraczki, Geneva: International Labour Organization.

Vickers, John, and George Yarrow (1991) *Economic Perspectives on Privatization*, in *Journal of Economic Perspectives*, vol. 5.

Welch, Dick, and Olivier Frémond (1998) *The Case-by-Case Approach to Privatization: Techniques and Examples*, Technical Paper No. 403, Washington: The World Bank.

VIII. PROMOTION OF COMPETITION

A. Dimensions of competition

One should always start off with a definition. What is competition? The broadest definition would be a situation in a market where firms or sellers strive independently for the patronage of buyers in order to achieve a particular business objective, such as profits, sales or market share. I want to stress the word “independently”.

Firms are rivals. Rivalry requires two or more firms, but competitive behaviour can take place also when you have only one firm. So, for instance, you can have a monopoly given by auction, you can have performance contracts, you can have contestable markets by lowering various kinds of barriers to entry. A monopoly may exist in a structural sense, but it may behave in a competitive way.

I do not need to stress the importance of competition. The market is the primary allocative organizational mechanism for resources, and competition is the primary stimulus for the proper functioning of markets. When they do function properly, resources are allocated to their highest value uses, entrepreneurship and risk-taking are rewarded, innovation and progress tends to occur, and consumer welfare is maximized. In many areas, there is no need for government intervention. This is not an ideological issue, nor a stages-of-development issue. It is merely a matter of how to organize economic activity so as to maximize total economic and social welfare. Some conflicts may arise, and this is a matter for political choice.

Competition is a multi-dimensional concept. When we think of interfirm rivalry to gain the patronage of customers, this is conditioned by the nature of export competition and domestic competition. There are non-price dimensions of competition such as quality, variety, service, choice and image. While these are important, they are difficult to gauge, so economic theory tends to emphasize prices. Non-price dimensions may sometimes be brought into the theory by asking consumers to value them, for instance, by asking respondents whether they would switch brands for a price difference of (say) 5 per cent.

It is important to ensure the contestability of markets and this is where competition law and policy play an important role. Properly functioning markets reflect the preferences of consumers, and these in turn impact the investment decisions of producers. Our experience of the Asian crisis suggests more and more that the domestic price and profit signals were distorted. They led to wrong investment decisions and to excess capacity, excess debt and the scenario described earlier. So there's more to competition than the enhancement of efficiency. Under competition, the price signals guide correct output and investment decisions.

Markets can fail to allocate resources optimally, due to four kinds of failure: imperfect competition, public goods, externalities and lack of information. I want to focus on the first kind of failure, that is, monopoly, oligopoly and the exercise of market power. Competition policy has become an increasingly important area for the World Bank. We are talking about those kinds of micro-industrial policies and government interventions of various kinds that affect market

structure and market performance. There are two sets of policies, first, microeconomic policies such as trade, regulation, and investment, and these impact market structure and the behaviour of economic agents in those markets. Then there is competition or anti-trust law. This is an area that has grown more important in recent years. Since 1990, more than 35 countries have enacted anti-trust laws around the world, including several centrally planned economies. To do this, countries promote deregulation and liberalization, and prevent anti-competitive business conduct, both for State-owned and private enterprises. Competition policy is characterized by its general application to all sectors and all firms.

B. Insufficiency of deregulation and liberalization

We are familiar with trade policies such as tariff and non-tariff barriers, countervailing duties, anti-dumping laws, discriminatory export practices, and with investment policies such as exclusionary lists, and licensing and domestic content requirements. Government action in these areas can encourage or impede competition. These policies need to be redirected more toward competition. Sometimes this is not entirely possible, but one should still strive for the second best.

Earlier when I was working with Mark Dutz in the World Bank trying to market this message, many people would say that deregulation and liberalization policies were sufficient to curb anti-competitive business practices and that one did not need a specific competition law. This view emanated from an article by Bhagwati in 1965 which has since been amplified and modified. In fact, deregulation and liberalization policies do not replace competition policy, as markets are segmented by more than just tariff and non-tariff barriers and regulations. There are transport costs, transaction costs, domestic and international cartels, non-tradeable products, and various kinds of strategic business behaviour by incumbent sellers, such as implicit contractual arrangements, exclusive dealing agreements of various kinds, and product and technical standards. All these factors can limit competition. Six or seven years later, many of my colleagues recognise that, while we have implemented trade liberalization policies in several Bank member-countries, the expected cornucopia of results have not materialized. There are still differentials between domestic and international prices, there are still barriers to entry, no new flow of investment is necessarily taking place, and this is because of various impediments that incumbent firms can raise.

One needs to think of the objectives of competition policy. There is a continuing debate whether policy should solely be concerned with economic efficiency or should it have broader public interest objectives. The latter may need a Competition Office to play the role of a national planning organization, which can balance possibly conflicting objectives of employment, regional development, consumer welfare, producer welfare, etc. This is difficult. The message of

the Bank is that economic efficiency should be the primary if not the sole objective of the law in order to get consistency in its application. Other objectives are important but they should be addressed by other specific instruments, rather than trying to embed them within a competition law.

As to policy instruments, there are structural approaches. In Indonesia, which is enacting its first competition law ever, they had drafted a law to break up any firm which would have more than 35% of the output in the economy. The Bank advised to focus on the business environment.

I want to emphasize that it is not just a monopoly problem of high prices, low output and misallocation of resources, but also a cost problem. At all levels of output there is x-inefficiency and dynamic inefficiency: costs are not minimized. So competition policy targets market power and abuse of dominant market position. Market power is the ability of a firm, unilaterally or in collusion with others, to profitably raise its prices and maintain them over a significant period of time, without competitive response. This concept is embedded in the competition guidelines of Canada, The United Kingdom, The United States, etc. Guidelines deal with structural problems such as dominant market position, mergers, joint ventures, etc. Behavioural provisions deal with horizontal constraints, such as collusion, territorial agreements, bid rigging, conscious parallelism (especially in duopoly and oligopoly situations), price discrimination of various kinds and exclusive dealing. In The United Kingdom, a privatized utility knows that the Office of Fair Trade can investigate its pricing and business behaviour if it abuses its position. There are sometimes provisions, as in European law, against excessive prices, but these are difficult to define and it is better to focus on the firm's behaviour in relation to its environment. There may also be provision for specialization agreements which allow for the rationalization of industrial structure. These are very important in transitional economies where many firms have excess capacity. Special exemptions may be made in the law to allow for industrial rationalization. There are provisions for research and development cooperatives for those who believe in the creative-destructive approach to economics. Firms can get together and cooperate to innovate, provided this does not get in the way of competition, eg. Phillips and Sony cooperated in the development of the cassette and the compact disc, even though they compete head on in the consumer electronics market. There are also policy links with intellectual property, tariffs and regulatory interventions. Competition offices are increasingly playing a general role in economic policy decision making.

Competition offices can also abuse their bureaucratic power, so there need to be checks and balances. Generally the ideal competition office is driven by complaints from consumers,

and at times there may be a government initiative because they see developments taking place in the market structure. The investigation and prosecution is generally done by a government department or agency, and adjudication and imposition of fines is done through the courts or a special tribunal. We usually recommend a special tribunal because this is a complex area, and judges are not generally versed in treating these kinds of issues. There must also be right of appeal. In case the government agency becomes captive to the producer interest, there needs to be some provision for private actions, but not as in the US where private actions are used as ways of recovering losses in the market place.

C. Instruments of competition policy

How can market power be curbed? There is specific application of competition law against private constraints to business in the market. Prohibition of price fixing and other collusive agreements should generally be backed by severe fines. You also need to prevent abuse of market position, recognising that the dominant market position of a firm may be due not only to barriers to entry that it has erected or to its preferred access to particular resources, or whether it is due to superior economic performance. Indeed that is now being debated in the Microsoft case. You need prevention of concentration by controls on merger and acquisition activity. In The Russian Federation, for instance, though the law existed, it was not applied effectively through the privatization programme and this led to significant concentration of the economy. One also needs pro-competition micro-industrial policy to reduce barriers to entry and foster contestable markets.

Where in the normal bureaucratic structure would you find arguments for competition. Ministries of finance and treasuries usually have conflicts of interest, especially in privatization, since they would like to get the maximum value for the assets. You usually find ministries of commerce and trade lobbying for domestic protection of trade and industry. Ministries of employment argue for maintaining employment. Ministries of regional development talk about about subsidies and special measures. In all this, the consumer is the loser. So where does one hear a coherent, cogent voice for competition? Logically that would be the role of a Competition Office, as an advocate for competition. Since there is generally no single institutional focal point for competition, the competition advocacy role becomes very important. Someone has to counter the vested stakeholder interests. Competition advocacy creates the need for accountability and transparency in government economic decision making. There are different institutional designs for this. You can have a strongly led Competition Office which publicizes anti-competitive policies and tries to win over public opinion. Or moral suasion may be exercised behind the scene, as in Hungary. In The United States, the Federal Trade Commission and the Antitrust Division of the Department of Justice do not have a formal competition advocacy role. But

because of public interest suits that can be brought before regulatory bodies, they can intervene before the Civil Aeronautics Board or Public Utilities Board to resolve situations which they feel are anti-competitive. They played a very effective role in the deregulation of the airlines and telecoms. In Canada, on the other hand, the Competition Office has a statutory role that not even Parliament can exclude. The Director has full rights to intervene and put forward pro-competition arguments and solutions. A competition office should not be driven by complaints from producers, as these are generally self-serving. When I was working in the Canadian Competition Office, General Motors, Chrysler and Ford brought an anti-dumping suit against Hyundai Motors. Our analysis did not support their argument. We found that the statute was being used to limit competition. We intervened and the consumers were better off.

D. Conclusion

In some countries regulation has unfortunately evolved from being a complement to competition to being an antithesis of competition. It has not led to lower prices, better services, etc. On the contrary, it has led to a burgeoning bureaucracy, fiscal drain, and so on. The interest of the industry has taken precedence over the interest of consumers.

Consumer welfare is extremely important. The purpose of all production is consumption. Investment is merely postponed consumption. If investment is inefficient, one is impeding consumption. Why are local producers often favoured at the expense of local consumers? Historically, we know that countries that protected their producers did not lead to higher consumer welfare, but to high prices, shoddy products and poor innovation. Consumers have been treated shabbily. There is no systematic relationship to show that protected firms are more innovative or dynamic. Indeed, many major innovations have come from small unprotected firms. The Asian tigers are not really an exception: they grew rapidly behind protective barriers, but analysis shows that Japan and, to some extent, Korea, had healthy domestic competition as well as competition in export markets.

In summary, one should reduce barriers to mobility of resources. One should think about competition policy as distinct from deregulation. One needs to condition the business environment so that effective competition prevails and reduces the need for costly government intervention. Competition policy is one of the four framework policies, along with monetary, fiscal and trade policies. Competition should become integral to business-government relations, culture and ethics. If one does not have competitive pressures, what incentive is there either to static or dynamic efficiency?

IX. VALUATION AND FINANCE ISSUES IN PRIVATIZATION: THE PERSPECTIVE OF A GOVERNMENT ADVISER

A. Introduction

Privatization was recognized in the 1990s as one of the critical components of economic growth and reform. The 1990s have also been a period of tremendous innovation and learning for governments undertaking privatization programmes. Wholesale, or mass, privatization programmes, were introduced in many countries, especially in central and eastern Europe and the newly independent States of the former Soviet Union (CEE/NIS). These programmes represented a bold new technique, and signalled a reliance on public auctions and competitive tenders on a scale never seen before.

Much has been written about what went wrong with these “wholesale” privatization systems, particularly in the literature describing the many negative outcomes of programmes in The Russian Federation, the Czech Republic and others. This cannot be denied. This paper does not seek to re-hash this debate.

Rather, we should reconsider what our experience implementing these wholesale systems has taught us about the role of valuation and financing in privatization. We believe there are valuable lessons to be drawn.

First, the experience with auction systems

demonstrates very clearly the power of the market as a valuation tool in developing country contexts. Most of the auction systems downplayed the role of sophisticated valuation techniques. They relied instead on simple approaches in order to establish a starting price (e.g. book value). From there, the market, through public bidding or competitive tenders, determined the value of the enterprise or assets being transferred.

We believe that there should be a movement away from complex valuation exercises. As the next wave of privatization is undertaken we should rely on systems (e.g. auctions, competitive tenders) that allow price discovery in a public and transparent manner.

Valuation is not an exact science. Expending vast amounts of time and effort on consultants to carry out valuation has at times been more wasteful than productive. The limited resources of developing governments are better spent creating and strengthening market structures that will allow market forces—whether in the form of competition or through the creation of trading structures—to determine the true value of the State-owned enterprises. Reliance on market-based systems rather than case-by-case negotiated solutions can also help reduce the opportunities for corruption.

In addition to providing valuable lessons on the role of valuation, the recent experience with privatization illustrates the importance of developing appropriate capital market structures, and of mobilizing local capital. Wholesale privatization processes *were* very successful in achieving transfers of asset ownership from the State into private hands. However, they did little, if anything, in terms of providing finance for these newly privatized entities. Moreover, in the absence of a market for the shares of newly privatized companies, and a robust “take-over” market, there were precious few mechanisms to discipline the management of the new private companies. And there were relatively limited means to raise capital needed for restructuring—foreign or local.

The result: a huge cohort of “sick” companies—ill managed and undercapitalized—has plagued the economies of the CEE/NIS region. In short, the basic problem with wholesale approaches to privatization (e.g. mass privatization programs) is not with the mechanisms developed to value and transfer assets, but with the lack of what we will call a *supporting market infrastructure*.

Developing viable local capital markets, and encouraging programmes that foster the mobilization of local capital for privatization is particularly critical for infrastructure projects. Shallow, domestic capital markets increase the costs of financing, increase the volatility of local markets, and discourage long-term investor commitments. The success of the next wave of privatization will depend on the effectiveness of

mechanisms to mobilize local investment.

B. Valuation

In theory, valuation is a seemingly straightforward exercise. Various methods and formulas exist on computing the value of a company (Appendix A). These formulas lend a misleading air of certainty to these exercises. We found in our work that in many cases, government clients have expected valuation to be a science. Our challenge has been to show them that valuation tools only “work” if certain underlying assumptions regarding the efficiency of capital and other markets are met.

In most transition economies, for instance, very little information is available about the enterprise that is accurate, much less current. Moreover, uncertainties regarding the condition of a rapidly transforming economy make it difficult to get any precision regarding the intrinsic value of the assets.

If we were to seek the value of any blue chip company from a pool of investment analysts operating in a “developed” market, the chances are we would receive a broad range of values, rather than a consensus on a single price. In spite of all the information accessible to the public, from historical and current financial statements to business plans, each analyst may still see a different picture. They may vary on the valuation method employed or more importantly, there may be a wide disparity in their underlying assumptions, both at the macroeconomic and the firm levels. Their outlooks on the industry, competition, substitutes, or even their estimation of managerial talent within the firm, determine much of their expectations of the firm’s future value.

The result of the valuation process, therefore, must be a well-conceived range of values for the enterprise. In the context of privatization, it must allow an appropriate balance to be struck between providing

adequate returns to the investors (proportionate to the risks involved) and generating revenues to the government through a fair price. Furthermore, they must arrive at a set of conditions that ensures the future viability of the business and maintains the welfare of the employees.

Unfortunately, the lesson of valuation as an inexact science has not been easy to learn. Political expediency (e.g. government officials often believe that the more financially rigorous the valuation is, the more politically defensible the sale will be) and the investment banking culture brought by most Western financial advisors, has led to the construction of sophisticated valuation models in perhaps too many privatization exercises.

This is not to suggest that conventional valuation techniques are useless or should not be applied. Rather, their results should be viewed with an understanding of this uncertain and evolving context. There is never "one right answer". The quality of the results of the valuation exercise is a function of the accuracy of the inputs used and the validity of assumptions made. The adage "garbage in-garbage out" rings true in this setting. Ultimately, we believe that resources are better spent developing and strengthening market-based mechanisms for price discovery, rather than relying on armies of investment bankers to conduct a valuation.

Valuation under various privatization techniques

In the earliest years of transition, most countries in the emerging market economies of central and eastern Europe and the newly independent States of the former Soviet Union (CEE/NIS) region preferred to take the case-by-case method of selling State-owned enterprises to outside owners. It had been the best-known model given its success in the advanced economies and even in the middle-income developing countries in Latin America and Asia. From 1988 to 1993, 60.7 per cent of privatization revenues came from direct sales while 35.6 per cent came from public share offerings. Other methods accounted for only minimal revenue.⁷⁶

But privatization during this period was taking place in an environment where much of the basic market infrastructure was in place. For instance, the governments of Chile and Mexico had undertaken comprehensive macroeconomic reform. Starting in 1974, Chile liberalized trade, lifted import restrictions, reduced tariffs, and deregulated

⁷⁶ Source: World Bank Global Privatization Statistics

industries in which State-owned enterprises competed with private firms. These reforms were accompanied in the early 1980s by the establishment of sound supervision and regulatory mechanisms. The Mexican government similarly began instituting reforms in 1983, ranging from the reduction of import tariffs to the removal or easing of price controls. In this context, valuation (as part of a trade sale or an IPO) was more meaningful. Many of these SOEs could also be compared with and priced against other firms in the industry with whom they competed in more or less similar circumstances.

In contrast, entire economic systems were reformed and market mechanisms were created virtually overnight in the CEE/NIS region. Privatization was being implemented at the same time that governments were creating institutional, regulatory and macroeconomic reforms—reforms that should ideally have been introduced prior to divestment. Financial reporting systems rarely existed, rendering much of the accounting data of their State-owned enterprises unreliable. In some cases, new legal forms of business ownership and operation had to be defined and codified in a Commercial Code. Most of these countries lacked market mechanisms, complicating valuation further. Laws on asset valuation, liquidation and bankruptcy were still being determined.

In this context many of us quickly learned that valuation was a time-consuming and expensive proposition. Privatization itself needed to be rethought. The sheer number of enterprises "on the block" called for innovation, if there was any hope of getting through the daunting task of transferring so many enterprises into private hands.⁷⁷

In addition to the sheer volume of State assets to be divested, the lack of information available on those assets also ruled out strategic or direct sales for most cases. Also, given the need to foster transparency and to create a vested interest in reform among the general population, it was critical to avoid sole-source negotiations. And having a single bidder weakened the bargaining position of the government and exposed the process to the risks of corruption, vested

⁷⁷ Remember that in the early 1990s we all believed that we had a limited "window of opportunity" to make privatization happen. Everyone working on economic reforms and privatization believed it was important to move as quickly as possible so that the process would become irreversible.

interests, and political backlash.

Mass privatization programmes allowed a rapid transfer of ownership into private hands, particularly in countries suffering from a shortage of domestic capital available for investment. It also provided a means of promoting fairness in the distribution of ownership of State-owned enterprises. Vouchers attracted the participation of individuals who otherwise would not have had the capital nor the experience to be involved in privatization. (See Table 1).

Mass privatization programmes can best be described as non-cash share distribution programmes. These programmes have enjoyed the advantage of being relatively more transparent, with initial share values usually set at nominal book values which are instinctively understood by most governments. A centralized auction of shares is then conducted, which permits the simultaneous sale of a large number of companies. By providing management, employees and the general public an opportunity to acquire ownership of former State companies easily (and cheaply), these programmes have encouraged support of the privatization process and the larger landscape of market-based reforms. They have helped to create a new class of investors and owners in countries where the idea of private property and ownership had not existed for decades.

Over 20,000 medium and large enterprises have been privatized in The Russian Federation, the Ukraine, the Kyrgyz Republic, the Czech Republic, Moldova, Slovakia, and the Baltic States through mass privatization. While they differ in terms of how they have been implemented, these mass privatization programmes share a fundamental characteristic: ownership transfer requires little or no capital. Throughout the CEE/NIS region literally hundreds of thousands of enterprises have been privatized in record time. Figures in Table 1 (above) show that, with the exception of Estonia, sales to investors did not account for the bulk of privatization transactions in the CEE/NIS region, since the experience of transition economies was very different from the rest of the emerging markets. Management-employee buy-outs,

for instance, allowed the rapid transfer of enterprises from the State into the hands of the employees and officers themselves, making this among the favoured approaches along with voucher privatization.

Thus, in our view, mass privatization was a positive development because it forced us out of the confines of traditional privatization structures. It steered us away from individually negotiated deals and brought us towards market-based valuation and greater transparency in the sale process. These were positive developments, and represented an advance in the thinking about privatization techniques.

We must acknowledge, however, that mass privatization has come under a great deal of criticism in recent years. Critics argue that, apart from the more obvious drawback of not bringing in revenues to the government, voucher systems have not led to any significant level of effective enterprise restructuring.

In part this is a result of the fragmented ownership structure that emanated from many of these sales. The voucher "capital" of any individual purchaser was usually insufficient to allow him or her to acquire more than a small fraction of any one enterprise. The resulting ownership of the companies privatized using this technique has been extremely fragmented. No effective shareholder control has been possible in many

Table 1. Privatization Methods for Medium and Large Enterprises in Seven Transition Economies (% of all former SOEs, as of December 1995)

Country	The Czech Republic	Estonia	Hungary	Lithuania	Mongolia	Poland	The Russian Fed.
Sale to outside owners	32	64	38	<1	0	3	0
Management-employee buy-out	0	30	7	5	0	14	55
Equal-access voucher privatisation	22	0	0	70	70	6	11
Restitution	9	0	0	0	0	0	0
Other	28	2	33	0	0	23	0
Still State-owned	10	4	22	25	30	54	34

Source: World Development Report 1996

Mass Privatization in the Czech Republic. Mass privatization owes much of its success to the emergence of the investment funds as market makers in the region. In the Czech Republic, a young Czech returning from studies in the United States set-up Harvard Capital, an investment privatization fund (IPF). This IPF sparked the public's interest as it aggressively guaranteed a 1,000% return to those who chose to entrust their privatization vouchers to his fund. Suddenly, what had been an apathetic public began to take a keen interest in the mass privatization programme. Citizens began claiming their coupons by paying a nominal fee. Although Harvard Capital never did give its investors a 1,000% return, its success as, well as those of other Czech and Slovak IPFs, made them major players in the newly privatized enterprises. The results of the first wave of privatization in these republics indicated, for instance, that IPFs accounted for 72% of all voucher points invested by the public. IPFs

cases. This has in turn resulted in weak corporate governance, if any at all. More critically, it has allowed unscrupulous insiders to control and mismanage the enterprises to pursue their own interests.

In cases such as the Czech Republic, the emergence of voucher investment funds (VIFs) did allow for ownership concentration, but because State-owned banks often controlled these funds, such ownership structures have generated its own set of conflicts and poor decision-making.

represent "post-privatization" problems, rather than fundamental

deficiencies with the auction-based approach to ownership transfer. Mass privatization was an invaluable tool for *transferring ownership*. Transactions were generally conducted effectively, transparently and in a manner that created buy-in by the population, at least initially. It represented a stark contrast to the closed-door deals often carried out in the past. It provided a defensible approach that relied on creating a market for shares or assets, where no markets had existed in the past.

Mass Privatization and the Legal/Regulatory Structure. The mass privatization programme in Russia is a prime example of a transaction process that has run at a faster pace than the creation of a legal and regulatory structure to support it. As a result, critics point out, privatization has not led to the much-vaunted improvements in enterprise efficiency. Competition, the hallmark of free market operations, has not really taken root. Moreover, the absence of clear rules of the game has led to widespread cynicism and distrust of "capitalist" structures. Widening disparities between the "winners" and "losers" in this economic game and deteriorating standards of living have hurt the credibility of the reform process.

On the other hand, there are many reasons behind why privatization had to precede the creation of a legal and regulatory framework for private business. Foremost among these reasons was the political need. There was a perception that no time could be afforded to develop the appropriate legal and regulatory structures as this would have meant delays, and perhaps costly expenditures of political capital to get regulations and laws passed. Given the political situation at the time, the choice was clear—build momentum for the privatization process and then worry about the legal and regulatory infrastructure.

The underlying cause of failure was that these sales took place in a legal and institutional vacuum, which lacked corporate governance, laws and controls, as well as well-proven checks and balances. The absence of stock exchanges in most of these countries also prevented the new owners from voting management out with their "feet"—by exiting or selling their shares when dissatisfied with the performance of the firms.

In summary, valuation is best performed by the market rather than by advisors and sophisticated financial models. Meanwhile, the effect that market institutions, transparent procedures, proper regulation, fair competition, and enforceability of rules, have on investor interest, confidence, and subsequently on share value, cannot be overemphasized. Resources spent on valuation consultants might be better spent on designing and implementing tenders and share auctions that rely on competitive bidding to determine the price of the assets being transferred.

C. Financing privatization: The challenges ahead

In the preceding section we tackled one of the key challenges facing privatization advisors in the decades ahead: how to conduct tenders in a manner that creates public support, and minimizes costs and the opportunity for corruption. We highlighted mass privatization programmes as an area from which to draw lessons in this regard. Mass privatization programmes however do not normally raise capital. Many problems regarding the implementation and financing of restructuring are left unanswered. This is precisely the issue faced by thousands of newly privatized joint stock companies in the CEE/NIS region today. The solution to these problems, and to the challenge of privatizing large public infrastructure effectively, is to mobilize

domestic capital.

Finance through mobilization of domestic capital

Large flows of private capital entered the emerging markets through most of the 1990s, spurring capital market development in these countries. Foreign capital entered through direct and portfolio investment, loans, and debt and equity issues. Expansion of local stock market capitalization in most of these countries could be traced directly to privatization, particularly in select sectors such as energy, utilities, banking and telecommunications. The capital flight associated with the recent Asian crisis, however, and the resulting contagion in the rest of the emerging markets, has reinforced the widely recognized need to seek mechanisms and techniques to mobilize domestic sources of capital. It is in this area that much work remains to be done, and where donors should play an increasingly important role.

By promoting the development of local capital markets, the array of funding sources widens, thereby lowering costs of financing as a whole. Domestic sources of capital also prevent the mismatch between local currency revenues and hard currency debt service, the harsh effects of which are currently being experienced by the numerous emerging market countries whose currencies have sharply depreciated. Local financing also alleviates political sensitivity (as national patrimony is preserved), improves external balance and reduces contingent liabilities of the government.

D. Infrastructure – the next frontier in privatization

Nowhere is mobilization of local capital as important as in infrastructure privatization. Moreover, infrastructure privatization often presents an interesting set of valuation (and therefore political) questions to governments, because much of the “value” is not in the assets themselves, but in the exploitation of the franchise. It is therefore fitting that we focus our discussion on infrastructure privatization as we end our discussion.

Private participation in infrastructure

Whether in the form of a stable power source, an efficient road network, or a reliable water supply, the

quality of infrastructure directly impacts business performance. Governments, however, remain

strapped for cash while infrastructure demands massive levels of capital that only the private sector can raise. The next wave of privatization activity will likely focus on infrastructure, with governments devising creative approaches to attracting private participation in infrastructure.

Granting concessions is one of various methods of involving the private sector in the provision of infrastructure services, a role viewed in recent decades as the responsibility of the government. Although the particular form of a concession may vary, the basic concept is simple: a private party or “concessionaire” leases assets from a public authority for an extended period. In return for user fees, the concessionaire is responsible for providing services, financing specified new fixed investments, and bearing commercial risk during the term of the concession. At the end of the concession period, the assets revert to the public sector.

A concession arrangement is a public-private partnership and is defined by the manner in which the public and private sectors share risks, responsibilities and rewards. Concessions are appropriate where a market has substantial unmet demand and promises high growth, but outright privatization is not feasible for legal, economic or political reasons. Other methods include management contracts, leasing

Role of Pension Funds. Many developing countries are discovering that, given certain reforms and types of privatization, the pool of investment capital created by the pension fund system can be tapped for long-term investment. Privatization activity has opened up new and attractive investment options for these funds. Pension fund investors have become important institutional investors in Chile, Malaysia and the Philippines. For example, in an effort to improve the liquidity of the local exchange, the Malaysian Ministry of Finance revised its investment guidelines for the Statewide Employee Provident Fund (EPF). In June 1995 the EPF, worth an estimated \$35.2 billion at the time, could invest up to 15% of its holdings in local equity shares, up from 9% previously. Searching for safe investments with long-term maturity and higher expected

arrangements, build-operate-transfer ("BOT") and build-own-operate ("BOO"). These four examples of involving the private sector may be viewed as spanning a continuum between public ownership (with minimal private involvement) to complete private ownership (with minimal public involvement). In a management contract, for example, the private party assumes no commercial risk and may be compensated according to productivity. The government, on the other hand, owns and finances improvements to fixed assets, investments and working capital.

Approach to valuation

A challenge in infrastructure privatization lies in convincing governments, as the sellers of the infrastructure, that in many cases what is being sold are not the assets of the entity but the right to operate that enterprise within that market—a franchise. This is particularly true for technology-intensive sectors, from telecommunications to port operation, where most State-owned enterprises carry obsolete equipment and virtually worthless assets.

Currency convertibility, regulatory environment, arbitration, and corporate governance structures are a few of the factors that potential investors will examine in determining how to price the relative degree of risk that a project presents. The pricing of these risks is what determines the cost of capital. This means that a country which is deemed unstable or risky should still be able to obtain financing for its infrastructure investment needs, but the expected return to the investors must be correspondingly higher.

With all these considerations, governments

must strike a balance between providing inducements to prospective investors and upholding the user interests of its citizens. A government may offer a minimum rate of return to an investor in a power plant, for instance, by guaranteeing to purchase power at certain tariff rate levels. At the same time, the government must ensure that the net benefit enjoyed by the general public, whether in the form of increased access to power, an increase in economic activity, or improvements in quality of life, is worth the price they pay.

E. Post-Privatization Support

We have learned that ownership transfer is not enough. New local shareholders typically do not understand their roles, rights or responsibilities. And in the absence of market discipline imposed through robust takeover markets, management has little incentive to change. Furthermore, speedy mass privatization by design does not generate significant, if any, revenues for cash-strapped governments. It does not allow for the infusion of much-needed new capital into the enterprises themselves.

Every privatization programme, most especially the case of privatization programmes that depend on the mass distribution of vouchers to the public, require two key ingredients for success: a strong public education campaign and a secure and transparent infrastructure to support the distribution, investment and trading of securities. Donor-funded programmes, in the form of technical market assistance and training, have been effective in creating and strengthening these basic institutions, all critical steps towards facilitating the mobilization of local capital in a country. Such actions make an enormous impact on the success of privatization programmes, and can create a virtuous cycle, helping local capital markets grow.

But there remains a need to develop wholesale approaches to tackling post-privatization restructuring—providing tools and training directly to the enterprise managers of the privatized enterprises.

Though hard data is difficult to come by, most observers agree that the bulk of donor funding for post-privatization, especially in the CEE/NIS region, has been channelled into the development of business support institutions. Among these institutions are the Business Support Centres in Poland (funded by the EC Phare programme), the Local Privatization Centres in Russia, (financed in part by USAID), and the Business Management Centres (supported by the World Bank, USAID and private funds). These institutions have attempted to fill market gaps and support reform by bringing in technical advisors to train local experts, faculties and consultants. This is fine, but it is not enough. More direct assistance is required.

Relatively little effort or resources have been channelled into strengthening the capacity of local business managers. It is critical to invest resources in the training of managers of firms that have undergone privatization. As we look forward to privatization in the next millennium, we need to focus on developing and disseminating a comprehensive set of tools and methodologies that local business service providers can adapt and apply to assist managers of these local companies. Otherwise the vast majority of newly privatized firms will almost certainly fail.

F. Conclusion

If the past 15 years have taught us anything, it is that “getting the deal done” is only part of the privatization process. Important issues, such as the creation of an appropriate legal and regulatory institutional framework for a robust local capital market, among others, need to be considered if newly privatized entities are to operate efficiently and if the public interest is to be served. This is not a new lesson, but one well worth repeating.

We believe that the world has learned a great deal about what works and what does not work from innovations carried out primarily in the CEE/NIS region. It was not our intention to conduct a comprehensive review of lessons learned in this paper. Instead, we wanted to draw the reader’s attention to

certain basic lessons from our experiences in that region that we believe practitioners might draw and learn from as they tackle privatization in the next millennium.

APPENDIX A. VALUATION TECHNIQUES

Various techniques may be used to estimate the value of an enterprise. There are six commonly used valuation techniques, three of which are “asset-based” and the other three, “earnings-based”. “Asset-based” techniques are based on the value of the firm’s assets, independently of the financial performance of the firm. “Earnings-based” techniques estimate the firm’s value based on the financial performance of the firm as an ongoing enterprise. In this appendix, we review the fundamentals of valuation approaches and discuss the advantages and disadvantages of each one. Ultimately, it is our view that while governments can rely on these to arrive at some notion of a starting point, it must be complemented by a market-driven method for price discovery. In the context of a privatization program, it is best to allow such market-based mechanisms as auctions, competitive bidding or tenders, and public listing in stock exchanges, to arrive at a “price”.

Asset-based valuation techniques

The three techniques discussed in this section—book value, liquidation value, and replacement value—esti

mate the value of a firm as equal to the value of the firm's total assets less the value of total liabilities.

Firm Value = Total Assets - Total Liabilities

The fundamental difference in the three techniques is

the method used for estimating the value of the firm's assets.

Book value

The book value of a firm is equal to the value of the firm's total assets less total liabilities as represented on the balance sheet. The book value, therefore, is based on the historical cost of fixed assets and the depreciation attributed to these fixed assets. However, book value may or may not approximate the market value of the firm, depending on how closely the historical cost and depreciation of the assets on the balance sheet approximate the market value of assets. For example, if a machine is completely depreciated on the balance sheet, then it will be listed as having no net value. However, that same machine may still be capable of producing goods and therefore have a positive market value. Book value should therefore be considered cautiously as a measure of the assets' worth.

Liquidation Value

The liquidation value of a firm estimates the value of the firm's assets as the cash that could be generated by selling the firm's assets to the highest bidder (either together or piecemeal). "Liquidity" refers to the ease with which assets can be sold for cash. Certain assets, like fixed assets, are less "liquid", or harder to convert into cash, than other assets like accounts receivable. The key assumption behind liquidation value is that the enterprise will cease to exist.

ref	Liquidation value = Cash potentially generated from sale of assets – total liabilities	
<p>it uses current market prices to estimate the value of assets rather than their historical cost. Liquidation value can be extremely difficult to estimate accurately in emerging economies, however, due to the lack of reliable market prices for land, buildings, machinery, and other assets.</p>		<p>incurred to replace the assets and productive capacity of the firm.</p>
<i>Replacement Value</i>	Replacement Value = Cost of Replacing Firm Assets – Total Liabilities	

The replacement value, like the liquidation value, has the advantage that it is based on current market prices. Unfortunately, it suffers from the same limitations: it can be difficult to estimate due to the lack of reliable market prices. This has been particularly true in the transition economies where there was a lack of market activity making it difficult to appraise land and buildings. In addition, replacement value is a more useful measure of value for some assets (i.e. fixed assets) than others (i.e. inventory).

Earnings-based valuation techniques

The following "earnings-based" techniques estimate the value of the firm based on the historical and projected financial performance of the firm as a going concern. These include discounted cash flow, comparable transaction analysis and comparable company analysis. The fundamental difference between these three techniques and the "asset-based" techniques is that "earnings-based" techniques estimate the firm's value based on expected future earnings. "Asset-based techniques," in contrast, estimate the firm's value based on the current value of the firm's assets, less its liabilities.

Discounted cash flow analysis

The discounted cash flow (DCF) technique assumes that the price an investor is willing to pay for an enterprise depends on the amount of cash that the enterprise is expected to generate in the future, and the degree of risk involved or the likelihood of actually receiving those cash flows. Cash flow is defined as: Net Income + Depreciation - Capital Investments. DCF analysis requires projecting expected cash flows and converting these cash flows into their present values using a discount rate (r). The discount rate is a factor that adjusts these cash flows to account for: (1) the time value of money, and (2) risk, represented as the probability of realizing the expected flows. The sum of the present value of the cash flows is the net present value (NPV) of the enterprise.

$$NPV = \sum_{i=0}^k \frac{\text{Cash flow}_i}{(1+r)^i}$$

The net present value of future cash flows is generally regarded as an accurate measure of firm value. It is

able to incorporate a broad range of information into the analysis, including the historical financial performance of the firm, the internal factors affecting company performance, and macroeconomic and political (external) factors unique to a particular region. For example, cash flow projections may be adjusted to reflect the strength of competition and industry growth trends, and the discount rate can be adjusted to reflect the risks of operating a business in an emerging economy.

The results of DCF analysis, however, are extremely sensitive to the underlying assumptions of the analysis. The critical factors that influence the results of a DCF analysis are the cash flow projections, the discount rate, and the terminal value.

Cash flow projections

Cash flow projections are commonly developed by applying expected growth rates to the current level of revenues and costs. Even a moderate variation in these growth rates can have a significant impact on the estimated firm value when projected into the future. Because of this, DCF analysis is generally performed for several different cash flow scenarios in order to identify a range of values that reflect the uncertainty of the cash flow projection.

Discount rate

The discount rate used to convert future cash flows to their present value is also highly influential on the results of the DCF analysis. Due to the difficulty of accurately estimating discount rates, particularly in an emerging economy, it is important to estimate firm value under a variety of discount rate assumptions.

Comparable transaction analysis

Comparable transaction analysis estimates the value of a firm by examining the price that investors have paid to acquire other firms similar to the firm under valuation. Comparable transaction analysis involves the following steps:

- Selection of transactions with target companies that are in a similar line of business and are of a similar size as the firm being valued;
- Calculation of valuation multiples for the acquired companies. Three commonly used multiples are the ratio of the price paid for the company to sales, operating cash flow, and net income of the target company; and

- Calculation of the value of the firm implied by the valuation multiples of the comparable transactions. For example, the average price/earnings ratio of the comparable transactions is multiplied by the current earnings of the firm under valuation to arrive at the implied value.

The advantage of the comparable transaction analysis is that it reflects the price investors have actually paid for other companies that are similar to the firm being valued and is therefore an accurate indicator of market value. The reliability of comparable transaction analysis, however, depends on several factors:

- The more similar the target companies are to the firm being valued, the more reliable the results will be. Transactions involving target companies that operate in businesses that are only vaguely similar or are much larger (or smaller) in size than the firm being valued may not be useful indicators of firm value;
- The more similar the regional economy of the target companies is to the regional economy of the firm being valued, the more reliable the valuation multiples. Valuation multiples for the acquisition of companies that operate in stable, developed regions may not be good indicators of the value of firms that operate in developing countries. Valuation multiples will tend to be lower in higher risk economies, although this difference may be offset if the higher risk economy is expected to experience higher growth than the developed economy; and
- The more reliable the sales, cash flow, and earnings figures of the firm under valuation, the

- more reliable the comparable transactions analysis. If sales, cash flow, and earnings figures for the firm under valuation are highly volatile or include extraordinary items, the application of the valuation multiples to these figures will not yield reliable implied firm values.

Comparable company analysis

The third and last of the earnings-based valuation techniques is "comparable company analysis." This technique estimates the value of a firm by examining the price that investors are willing to pay for shares in similar firms that are traded on public stock exchanges. Comparable company analysis involves the same steps and caveats as the comparable transactions analysis. The results of the comparable company analysis, however, do not reflect the 20% to 40% premium that investors commonly pay to purchase a controlling interest in a company. Thus, the results of the comparable company analysis tend to be lower than the results of the comparable transactions analysis.

If a majority stake of the firm under valuation is expected to be sold to a single investor, then the comparable transaction analysis may better reflect the market value. If, however, ownership of the firm will be diffused, then the results of the comparable company analysis may better reflect the market value of the firm.

X. REGULATION POLICIES CONCERNING NATURAL MONOPOLIES

A. Introduction

Recently, there has been a significant transformation in the style of natural monopoly regulation policies away from the previous almost exclusive reliance on public ownership. Once public ownership was hailed as a “reform”, but now privatization has become a “reform”. “Reform” today means deregulation, competition and privatization.

Privatization and restructuring of network industries traditionally viewed as natural monopolies have been gaining ground rapidly around the world since the early 1980s -- implying a radical shift in the focus of state intervention and a re-evaluation of the State’s role even as a provider of core public services.

Why then this change? And to what extent did this change take place, in particular in transition and developing economies? What are the empirical trends of natural monopoly sector development and regulation in these countries? Where are the current natural monopoly regulation models in these countries heading? What are their recent experiences in the domain of natural monopoly regulation?

After a discussion of what natural monopoly means and the major issues that are currently being debated in the area of natural monopoly regulation in section B,

we will examine the changes taking place in various network industries in section C.

Natural monopoly sector privatization is a relatively new and still-evolving field, and it would be premature to venture definitive conclusions as to the “best practice” privatization and regulation models for natural monopolies. Nevertheless, we will offer some recommendations concerning natural monopoly privatization and regulation in section D.

B. Defining natural monopoly and its current regulation policy agenda

Many network industries have been predominantly provided by a vertically integrated, often public, mo

nopoly. However, since the early 1980s the paradigm of public monopoly has been losing ground with the steady breakup of the activities traditionally regarded as natural monopolies (demonopolization) due to globalization of markets and technological progress. At the same time, growing dissatisfaction with public enterprise performance, ever-tightening government budgets, and the explosion of investment needs in utility and other network industries worldwide have caused policymakers to turn increasingly to private sector participation.

This *often intertwined* reform process of privatization and demonopolization of these industries initiated in the developed countries is also sweeping across the developing countries. In the wake of this change, the current agenda of regulatory policy concerning natural monopoly is not limited to the traditional price and entry regulation issues. *Rather, it includes the issues related to the design of regulatory institutions accompanying the restructuring, privatization, and expansion of competition in the area formerly occupied by regulated, often public, monopolies.*

1. The concept of natural monopoly, traditional regulatory practice and rationale

A natural monopoly exists when economies of scale are so substantial that a single firm can produce total business output at a lower unit cost, and thus more efficiently than two or more firms (Sherer 1980). In effect, the long-run average costs are falling over such a wide range of production rates (relative to demand) that only one firm can survive in such an industry. A more specific criterion is the subadditivity of the cost function. Natural monopoly gives rise to a potential conflict between cost efficiency and competition, with an increased number of competitors leading to some loss of scale efficiencies.

The typically quoted examples of natural monopoly are utilities (electricity, telecommunication, water, gas, and oil), transport (railways), with natural monopoly elements being centred on networks (Yarrow 1994).

An electric company is a classic example of a natural monopoly, where competition may lead to an

inefficient market outcome. Once the huge fixed cost involved with power generation and power lines are paid, each additional unit of electricity costs very little. Having two electric companies split electricity production, each with its own power source and power lines, would lead to a near doubling of price, because of low marginal costs, high sunk costs and declining average costs.

Natural monopoly thus poses the difficult *dilemma* of how to organize these industries so as to gain the advantages of production by a single firm, while minimizing all the vices resulting from non-competitive markets.⁷⁸

Traditionally, countries around the world, assuming the “inevitability” of monopolization, either regulated private enterprises or nationalized natural monopolies in order to deal with this dilemma.

A natural monopoly situation usually arises when there are large fixed costs and small marginal costs. The existence of a natural monopoly gives rise to the following problem: Allowing a natural monopolist to set the monopoly price is undesirable due to the Pareto inefficiency, and forcing the natural monopoly to sell at the efficient price (i.e., marginal cost-based price) is infeasible due to negative profits.

The solution to this problem was then to let the government operate the service, for example, at price equal to marginal cost and to provide a lump-sum subsidy to keep the firm in operation. This practice rests on the *assumption* that the imposition of public interest prices and standards may be achieved more effectively by the flexible decision-making inherent in the public ownership framework – considerable internal discretion, subject only to political accountability – than by legal controls of private firms (Ogus 1994, pp. 267-68). Otherwise, regulation of private monopolists has usually involved some form of price regulation and/or entry and quality regulation.

These regulatory practices were *theoretically underpinned* by the market failure argument, which provided the central economic argument for state intervention in industries with natural monopoly characteristics.

⁷⁸ These vices range from ‘deadweight welfare loss’ due to allocative inefficiency, productive inefficiency (or x-inefficiency) due to lack of competitive pressures, increased possibility of collusion among firms, increased possibility of ‘predatory pricing’ or ‘pre-emptive investments’ and other ‘wasteful’ behaviour to increased possibility of exploitation of consumers and of input suppliers by the dominant firms (Chang 1997, pp. 707-708).

Alongside other conditions such as public goods, positive and negative externalities, incomplete markets and imperfect or asymmetric information, natural monopoly is an important market failure situation (under which a market economy fails to allocate resources efficiently) that warrants regulation and nationalization. In fact, it is argued that the most serious market failure problems are likely to occur in network industries with natural monopoly characteristics. According to Yarrow (1994), this is because natural monopoly is combined with high-entry barriers. These industries are typically capital-intensive and require significant investments in long-lived, sunk capital facilities. Most assets are specific and durable, giving rise to high-entry barriers via extensive sunk costs. At the same time, the economies of scale in some industries such as water distribution or electricity are so great that the largest firm with the lowest costs could drive all other competitors out of the market.

It is important to note that regulation of natural monopolies also occurs for reasons other than market failure (generally considered a *static* efficiency problem). In fact, many real life regulations have been motivated by the concern for *dynamic* efficiency, distributional considerations and other considerations, including even 'moral' considerations – such as fairness.

In particular for developing countries, dynamic efficiency (or in other words, developmental) objectives such as growth are often more important than static efficiency. The most important dynamic efficiency consideration is, as Bradburd (1992) points out, whether an unregulated private monopoly will make the investments necessary to offer the quality of service appropriate to the country's changing needs over time. Natural monopolies' services are an important part of a nation's infrastructure, and if they are suboptimally provided, this can be an impediment to growth.

Thus, the new regulatory reform should give adequate attention to considerations of 'dynamic' efficiency. Some countries conduct their deregulation-based reform purely in terms of static efficiency, and the impacts of regulatory reform on productivity and growth are not duly considered when reforming the existing monopoly regulation policy. This is a highly inadequate approach, as Chang (1997) points out, as higher static efficiency will not necessarily lead to higher dynamic efficiency. In addition, removing 'distortions' in more, but not all, markets does not necessarily improve even the static efficiency of the economy. Schumpeter (1987) argued that monopoly rents

provide the incentive to innovate and, in the modern age of large-scale Research & Development, the resources to innovate. If this is true, there may even be trade-off between static and dynamic efficiencies. If the regulatory reform involves reductions in market power and the associated monopoly rents (e.g., by intensifying anti-trust regulation), the rate of innovation and productivity growth may be adversely affected.

Regulation practice is driven not only by normative considerations of reducing and controlling rent-seeking behaviour. The positive theory of regulation, based on public choice theory, treats the existence and forms of regulation as responses to the demands of politicians and other interest groups.

In summary, the traditional rationales and a wide range of (non-static efficiency) issues that traditionally belong to the realm of natural monopoly regulation policy may still remain valid and require adequate attention when "reforming" the existing regulatory regimes. While reforms may be necessary to make services more efficient and economical, the usual public service *raison d'être* of many natural monopoly industries also remains essential. Particularly in the developing world context, it is important to keep in mind that the ultimate objective of these industries is sufficient and sustainable provision of their services.

2. Forces of change, new regulatory agenda and theoretical alternatives

Recently, new developments such as technological progress, which offer means of contesting a monopoly, have fundamentally challenged the traditional regulatory practices based on the concept of natural monopoly. The steady breakup of "intrinsically monopolistic" network industries into separate elements has largely obviated the justification for the existence of large, vertically integrated monopolies.

There are increasing doubts whether some of the industries traditionally regulated do in fact have the structural characteristics of a natural monopoly. Many traditional natural monopolies have been shown to be less naturally monopolistic than was once thought to be the case.

The degree of natural monopoly of many industries has also been drastically reduced, due to technological progress and globalization of markets, though not eliminated entirely (World Bank 1997). Some even argue that there is nothing 'natural' about 'natural monopolies', challenging the *very concept* of natural monopoly (see for example Becker 1997).

- The most important challenge is technological progress, which changes the cost curves, hence *enabling* countries to re-examine the hitherto characteristic forms of natural monopoly regulation, i.e., price and entry regulation, based on the concept of natural monopoly.

New technologies evolved that are efficient at much lower levels of output than older methods of production. These have substantially reduced economies of scale and barriers to entry in many sectors, making at least some degree of competition for many natural monopolies a real possibility.

Development of new technologies such as wireless telephony and optic-fiber cable has created new scope for competition even with regard to basic line networks. In electricity, with combined cycle turbine generators, we have a low-capital-cost source of power, which cancels out economies of scale in generation and voids any argument that electricity generation is a natural monopoly. As a result, even in some traditional ‘natural’ monopolies such as telecommunications (e.g., long-distance and wireless telephony networks) and electricity generation, market competition has become both possible and desirable.

- The possibility of extending the market size due to globalization has undermined the economic rationale of monopoly retention policy. As Yarrow (1994) points out, whether or not an industry is a natural monopoly depends upon technology/costs and demand. Thus, natural monopolies can disappear or emerge as demand expands or contracts, even if production conditions do not change. According to Becker (1997), the growth of global competition implies that when large-scale production is most efficient, companies in small nations are no longer restricted to the inefficiently small scale of their limited domestic market. They can increase production enormously by operating in several nations.

What then are the consequences of these new developments for the natural monopoly regulatory policy debate? Which new issues and changed regulatory demands are then brought into the domain of regulation policy concerning natural monopolies?

The focus of regulatory policy concerning natural monopoly has clearly shifted with the evolution of technology and globalization of markets, which led to a steady breakup of natural monopoly and made more competition technically feasible. Instead of merely focusing on problems surrounding “inevitable” monopolization such as the pricing problem, the current regulation policy hence encompasses, above all, issues related to the design of regulatory policy accompanying the restructuring, privatization, and expansion of competition into the area formerly occupied by legal monopolies. In particular, the issue of *how to replace regulation with competition*, which is deemed as the best regulator, now occupies a central place on the current agenda of natural monopoly regulation.

Part of the debate over regulation concerns the limits of natural monopoly in the face of technological change. The vertically integrated, often public, monopolies have now been shown to be no longer monolithic entities. Rather, they encompass services that are arguably natural monopolies as well as services that are potentially competitive but need access to bottleneck monopoly or certain essential facilities to make competition in these supply segments feasible (Joskow 1998).⁷⁹ In particular, “unbundling” of monopolistic firms is considered as one of the most exciting ways to accelerate competition. Unbundling isolates residual sunk-cost facilities (e.g., the local loop in local telecom), leaving the contestable part of the industry under the control of market forces (see Teece 1995).

In practice, determining where the boundaries of natural monopoly is a difficult exercise, which requires detailed information on what may be quite complex cost conditions (Yarrow 1994). Nevertheless, a consensus has emerged for the need to revive the rules of market competition, whenever high fixed-cost activities cease to justify the presence of a single monopoly firm.

⁷⁹ Generally speaking, physical infrastructures tend to have monopolistic characteristics, and services competitive ones. See Guislain (1997, pp. 212-14) and Plane (1998, p. 14) on how to “unbundle” different sectors into their component activities. The organizational and institutional reform is then based on an economic analysis aimed at identifying the links in the technical chain where the cost function is sub-additive and the market is not contestable.

Consequently, out of this changed context, some issues have emerged as the new, important regulatory policy issues on the agenda. These are for example “unbundling” of a single monopoly, restructuring, and scaling back of monopoly protection through demonopolization to remove artificial monopoly privileges, while limiting legal, generally public monopoly protection to those aspects of the activity that justify the “natural” monopoly.

Additional recent developments on the *theoretical* front have enforced this *embrace of the competitive model*, as the right way to organize many network industries previously viewed as natural monopoly industries. Scholarly work has begun to emphasize that natural monopolies *do not necessarily* have to be regulated, since there are alternative ways to generate competition and discipline the firms, even if a natural monopoly structure exists within a market (Brauetigam 1989).

According to this argument, there exist the following theoretical alternatives:

- Competition *for* the market (or Demsetz-competition). One possibility is to retain the monopoly but to create competition between firms for the right of exclusive supply over a limited period, namely a franchise solution. This has been formalized as Demsetz-competition. The essential idea is that such competition *for* the market (i.e., the right to be the natural monopolist) may be an adequate substitute under some circumstances, where competition is not possible *within* the market. The outcome of Demsetz competition is in effect a contract between a franchiser (e.g., a governmental authority) and a franchisee. Monopoly franchises could be auctioned off to the bidder offering the most attractive terms, for example, the lowest price to consumers. Franchising schemes also may avoid pitfalls associated with traditional regulation of such industries or with their nationalization. Where competition cannot be introduced in the market, as tends to be the case for water supply, for example, it should at least be introduced for the market. Properly structured tenders or auctions will allow the government to extract part of the monopoly rents for the benefit of the treasury and the consumers (Dnes 1995, Brauetigam 1989, Guislain 1997).
- Contestable markets. A second way to introduce competition has been formalized with the concept of ‘contestability’. According to this concept, if an industry behaves as if it is contestable (due to the relatively costless entry

into and exit from the industry), most of the benefits of perfect competition can be attained without government intervention. The essential idea is that the *threat* of entry into an industry and potential competition may give an incumbent monopolist effective incentives to behave as if there were a competitive market. The key aspect of a contestable market and the key to guaranteeing competitive outcomes is therefore the existence of conditions enabling entry. According to Baumol, Panzar and Willig (1982), if one lowers artificial entry barriers and new entrants need not incur significant sunk costs, then all the benefits of competition will be available regardless of the market share of the incumbent. The *degree of contestability* of a market can then be measured by the share of the investment that is composed of sunk capital. Industries with substantial sunk costs such as the railroad industry are therefore not likely to be contestable, whereas industries in which capital is highly mobile may be contestable. For example, in the case of the airlines industry, it has been argued that airline markets are contestable since entry and exit is quite easy and there are virtually no sunk costs in the industry (Braeutigam 1989, Teece 1994, UNCTAD 1995).

- Intermodal competition. A third way to introduce competition is through intermodal competition. For example, in the transportation sector of the economy, monopolistic competition among various modes of transport (e.g. railroads and road transport) is often referred to as intermodal competition. The essential idea is that if intermodal competition is strong enough, it may become a basis for deregulation even if one or more of the modes of transport appears to have the structure of a natural monopoly. In recent years the move toward deregulation of the railroad industry partially results from pervasive intermodal competition among the railroads and other modes. In other industries similar types of competition have occurred. For example, cable television, a once heavily regulated industry, has largely been deregulated, in part because of heavy competition from over-the-air broadcasting. The same also applied to telecommunication industry with competition across market segments such as mobile and land-based communications. For example, in contrast to the sluggish growth and small size of the state-owned wireline network, wireless technology has taken off in Africa, fuelled largely by private investors (Braeutigam 1989, Teece 1994).

In addition to these alternatives, there also exists the possibility of introducing ‘yardstick competition’, which does *not* obviate the need for regulation, but *facilitates* the regulators’ task.

Yardstick competition is creation of entities whose performance can be measured, since the performance of one entity can be compared with that of another. According to this method, a firm with a natural monopoly is broken up into separate entities which supply different regions. Each entity retains its monopoly but only in relation to its own region. Yardstick competition can then be used as a regulatory tool to compare the performance of the monopoly operator with that of operators in other regions of the country and with international norms; the regulator can use such comparative information to justify tougher performance targets or tariff adjustments at the time of regulatory review (Ogus 1994, Foster 1992).

Would these alternative measures then *completely* obviate the need for regulation?

According to Joskow (1998), ‘complete’ deregulation policies are not likely to be realistic or effective policy options in most network industries. In most of the network industries subject to reform, certain important segments continue to be natural monopolies, and thus ‘competition in the market’ cannot be relied upon to yield satisfactory performance. In practice, ‘competition for the market’ through concession or franchise contracts must also confront problems resulting from significant sunk costs, asset specificity, and incomplete contracts. Moreover, the effectiveness of competition will depend on policies governing the initial structure of the competitive segments, the conditions of entry into the market, and the price and non-price terms and conditions of access to ‘bottleneck’ monopoly network facilities for competing suppliers, who need such access to compete effectively.

It is important to note, therefore, that market liberalization is not the same as deregulation (meaning that governments are relinquishing their regulatory powers). Regulation of natural monopoly industries is still crucial. Vogel (1997) finds that there is no logical contradiction between more competition and greater government control. What is necessary is the *redefinition* of the regulation policy: liberalization requires re-regulation, which implies the *reformulation* of old rules and the creation of new ones.

In fact, market liberalization and currently on-going privatization processes around the world themselves bring new regulatory issues to the fore. An example

is the need for regulation to address the common interconnection problem, for instance in telecommunications. Also in electricity, as competition moves from the generation side to the wholesale or even retail side, issues of third-party access will more and more come to the fore.

In addition, countries now have to grapple more explicitly with distributional impacts, which have to be carefully considered if they want to increase the chance of success of competition reform. Public ownership may have been selected specifically because it was considered the most appropriate legal form to achieve distributional goals (Ogus 1994). This applies most obviously to utilities, where it may be felt desirable to supply certain categories of consumers at below-cost prices so as to provide a universal service. Distributional effects resulting from “economies of density” following increasing competition or privatization driven mainly by efficiency (and budgetary) considerations make it necessary to introduce distributional considerations more explicitly into the design of regulatory reform, so as to minimize distributional side effects.⁸⁰

How did developing and transition economies then manage to bring regulatory systems in line with these new developments and complex regulatory demands and to find regulatory approaches that match both their specific, new regulatory needs and capabilities? To what extent did these new issues then actually reach the political agenda in developing and transition economies and result in reforms? The following section investigates recent responses and experiences of developing and transition economies in the area of natural monopoly regulation.

A. Actual responses and experiences in developing and transition economies

The actual speed with which the competitive model is being advanced in developing and transition economies has been rather slow, especially when compared with the privatization process itself.

⁸⁰ Economies of density means that costs of supplying a particular customer are significantly influenced by the spatial density of surrounding customers. Since competition tends to generate price structures that reflect underlying costs of supply, one consequence of competition in network industries is that the prices of physically similar products will tend to exhibit quite considerable place-to-place variations, often creating problems in the pursuit of distributional goals (Yarrow 1994).

1. Widespread privatization, but ambivalence towards real reform

The recent public finance crises in many countries, combined with huge investment requirements, have made private-sector participation necessary. Furthermore, the poor performance of most public enterprises and their inability to offer a quality service and meet demand have encouraged many governments to turn to the private sector for the provision of infrastructure services, leading to the need for reforms. However, large companies in developing and transition economies that were privatized were often sold as monopolies or near-monopolies. Instead of creating greater competition in the concerned sectors *before* privatization, all that has been accomplished is substitution of a private monopoly for a public one.⁸¹

Ideally, privatization of large network companies offers the government a unique opportunity to rethink and reform the entire organization and structure of the sector. Activities or services that were provided by an integrated, monolithic enterprise will have to be unbundled and competition introduced in those segments that can sustain it. Divestiture will very often be less important in itself than effectively demonopolizing and opening up the sector to competition (Guislain 1997). After all, the efficiency impact of privatization depends on the quality of government regulation and its ability to harness competition for sectoral reform.

While some may be convinced that private ownership leads to greater productivity,

⁸¹ An example is the privatization in 1994 of the East German electricity industry, which came under sharp criticism, as competition was limited and vertical integration was maintained. The public sector's monopoly was merely shifted to the private sector, thereby enlarging the area of domination of the private West German power utilities instead of breaking up the sector and introducing competition (Guislain 1997).

many authors such as Stiglitz (1998) find that an enterprise's efficiency is determined not so much by its *public* or *private* ownership as by the regulatory structure and the degree of competition under which it operates. By looking at the example of China vis-à-vis the former socialist economies, he concludes that effective competition and regulatory policies are important, rather than privatization *itself*. China had shown that an economy might achieve more effective growth by focusing first on competition, leaving privatization until later. In contrast, competition remains thwarted in many of the former socialist economies that pursued privatization first, demonstrating that without effective competition and regulatory policies, private rent-seeking can be every bit as powerful, and perhaps even more distortionary, than public rent-seeking. Moreover, there are those instances in which public enterprises have operated at a level of efficiency comparable to, or greater than, that of similarly situated private enterprises; typically these are associated with firms subjected to competition, either in exports (as in the case of Korea's steel industry) or domestically (as in Canada's railroads).

In practice, while privatization of traditional natural monopolies has become widespread in many developing countries over the past 10 years, their policies towards real sector reform have often been ambivalent. Certainly, there is much privatization, yet the actual degree of commitment to competition-based reform and the measure chosen vary considerably among countries and industries.

Some alternative measures to introduce greater competition have taken root in the developing world. Table 1 summarizes different modes of privatization and sector reform measures in some network industries.

A measure to introduce competition for the market via competitive bidding of concessions for instance, has taken root in power, telecommunications, railway, and water enterprises in developing countries as diverse as China, Guinea, Hungary, and Mexico. Countries like Argentina and Chile not only actively introduced competition in the market through vertical disintegration of their telecommunication or electric power enterprises, but also adopted yardstick competition measures in several industries to supplement their sectoral reform efforts.

Nonetheless, the *breadth*, *depth*, and *methods* of the private participation as well as of the sector reform remain highly uneven among countries and industries. For instance, Argentina and Hungary have chosen to unbundle the gas sector before privatization, introducing greater competition, whereas privatization has not yet been accompanied by unbundling or greater competition in the gas industry in The Russian Federation.

A sectoral and regional breakdown of this highly uneven process of privatization and reform in the developing world concerning natural monopoly sectors reveals the following overall picture.

Telecommunication and electric power lead the way

The bulk of privatization and demonopolization has taken place, above all, in telecommunications and then in electric power. Electricity has also become a leading network sector in attracting private participation and has been undergoing increasing restructuring based on deregulation of key parts of the industry and breakup of vertically integrated organizations and systems, through the separation of generation/transmission/distribution. This has for example already occurred or is planned in Argentina, Chile, Peru, Bangladesh, India, and the Philippines (Paddon 1998). Private sector involvement in water industry is yet a relatively recent phenomenon. Before 1990 private participation in water was rare, except in francophone countries, and it still remains small relative

to private participation in other network industries (Silva, Tynan and Yilmaz 1998, Izaguirre 1998) As for the *forms* of private participation, there is also a significant sectoral variation. Divestiture of public water and railway assets is comparatively rare. Few railways have been truly privatized. Instead, most governments have preferred to concession or franchise their railways. In water, concessions are the most popular form, where concession contracts have allowed governments to maintain ownership of sector assets while delegating substantial responsibility and risk to the private sector. Most water and railway assets remain in the public sector, and governments are resistant to giving them up. This highlights the sectoral difference in asset ownership between water and railway on the one hand and energy on the other (Silva, Tynan and Yilmaz 1998, Thompson and Budin 1997).

Latin America and East Asia dominate

In most network industries (such as energy, water, and telecommunication), Latin America and East Asia (including the Philippines and Malaysia) dominate private sector participation trends and restructuring process; and within each region, a few countries lead the way (Silva, Tynan and Yilmaz 1998).

- In particular, the Latin American region has a rich fund of experience in privatization and restructuring of natural monopoly industries. A few leading countries, such as *Argentina, Chile, and Peru*, privatized major network industries relatively early on as part of broader economic reform programmes, in order to overcome major bottlenecks caused by the inadequacy and poor state of public utilities (Guislain 1997). Among Latin American countries, Argentina is the country that has gone furthest in matters of privatization in Latin America since 1990 and has been at the forefront of various network industries' reform process, by introducing competition in the market through vertical disintegration.

**Table 1: Network industries: Modes of privatization and sector reform
(Selected developing and transition economies)**

Mode \ Sector	Divestiture	Concession and leasing contracts (periodic introduction of competition for the market through competitive bidding)	Introduction of competition in the market (e.g., through vertical breakup of integrated companies)	Yardstick competition
Telecom (wireline voice) Active privatization and competition-based reform	Argentina, Chile, Cuba, Guinea, Hungary, Jamaica, Mexico, Peru, Venezuela	China, Cook Islands, Guinea-Bissau, Hungary, Indonesia, Madagascar, Mexico	Chile, Mexico, The Philippines	Argentina (basic telephone services), Tanzania (basic telephone services)
Electric power (generation) Active private participation and unbundling	Argentina, Bolivia, Chile, Hungary, Pakistan, Peru	China, Côte d'Ivoire, Guinea, Hungary, Mexico	Argentina, Bangladesh, Bolivia, Chile, India, Peru, The Philippines	Argentina (distribution) Chile (distribution)
Gas (transport and distribution)	Hungary, Latvia, The Russian Federation	Argentina	Argentina, Hungary	Argentina (distribution)
Railways Mainly franchising	Bolivia	Argentina, Brazil, Côte d'Ivoire-Burkina Faso, Chile, Mexico		
Water (distribution) Relatively small private participation; concession preferred		Argentina, Brazil, Chile, China, Colombia, Côte d'Ivoire, Guinea, Hungary, Macao, Malaysia, Mexico, Senegal		

Note: The table includes only countries that have privatized by transferring existing public-sector facilities to the private sector, not those that have opened up the sector in question through greenfield concessions or BOT and BOO contracts only, such as Thailand (telecommunications) and China (power generation).

Source: Dnes (1995), Guislain (1997), Nells and Neil Roger (1994), Otobo (1998), Paddon (1998), Plane (1998), Thompson and Budin (1997).

- In Asia, despite its clear dominance of investments in projects with private participation, the divestiture trend has not been as pronounced. Few countries there have adopted or implemented large *full-scale* privatization programmes. Even in telecommunications, divestiture of the dominant operator has been partial with the government continuing to be the controlling shareholder (e.g., Telekom Malaysia with a public floatation of 25 per cent of the shares in 1990) (Guislain 1997). China has also taken a cautious approach to opening certain sectors such as electricity to private investment, and mainly relied on joint ventures between private sponsors and state-owned enterprises (Izaguirre 1998). The major rationale given for network industry privatization in the region has been the need to introduce the additional resources necessary to extend access to the service, improve service quality and modernize the system (Paddon 1998). There is little substantive evidence in the region of an improvement in the quality of utility services after privatization, leading to questions regarding the guarantees for adequate service quality and pricing

written into privatization arrangements.⁸²

- In Africa, a number of supplements to privatization have been explored. In particular, leasing contracts and concessions are viewed as promising arrangements, which provide an inducement in that they place an appreciable part of the risk on the private operator. Some African countries such as Cote d'Ivoire already provide some examples of these forms of privatization. African privatization has been most of all motivated by the new financial constraints. Insufficient public money is forthcoming, putting African governments in difficulty in financing

⁸² In Manila's water privatization, NGOs claim that the contracts with concessionaires provide for inadequate health standards, and lack appropriate environmental standards. In Pakistan, there are complaints about electricity privatization resulting in doubling of electricity prices in one year so as to accommodate demands by foreign investors for higher profits paid in foreign currencies. There are also the concerns about the pricing agreements reached by the Pakistan Government with transnational corporations to induce them to invest in new independent power producers. As far as the effects on price are concerned, in each of the utilities, the evidence from across the region is that privatization and restructuring are associated with increases in prices and charges for some consumers and have generally been disadvantageous to domestic consumers (Paddon 1998).

- the development of utilities, with the result that African governments are unable to improve their public services. For electricity alone, according to the World Bank, those governments will need to invest a total of US\$17 billion between now and the year 2005. African States themselves will not be able to provide more than US\$5 billion and funding sources US\$2 billion (Plane 1998).
- In transition economies, privatization in general has been a tool of transition. It has been used to establish property rights, to form a private sector and the basis of a market economy, to enable efficient governance and management of formerly state-owned enterprises. Yet, privatization of natural monopoly sectors was usually not featured during the early years of reforms. Instead, reduction of price subsidies has been a feature of transition in some countries (e.g., Lithuania), partly in preparation for privatization. In particular, increasing energy prices to cover costs, and increase profits, has been a painful process in many transition economies. The general trends with regards to energy privatization for transition economies are to move towards increasing prices; decentralizing distribution to local authorities; and some privatization, especially production. Private participation in electricity has been concentrated in the Czech Republic, Hungary, Kazakhstan, and the Russian Federation with some vertical unbundling of existing firms. Privatization of water in the region has so far been restricted largely to two countries, the Czech Republic and Hungary, with a couple of cases in Poland. Restructuring by decentralization has taken place more extensively, though this decentralization has probably reduced efficiency. In particular, the problems encountered by competitive restructuring initiatives in Russia point out the following barriers to reforming natural monopolies that are particularly important in The Russian Federation and, by extension other transition economies: the first is political opposition from the management of the firms themselves (e.g., Gazprom). The second obstacle to reformed natural monopoly regulation lies with the subnational authorities. The regional authorities' dual role as owners of regulated firms and as the principals to which the regional regulatory commissions are subordinated has not worked well. Moreover, much of the so-called "privatization" has really been the transfer of ownership rights from the federal to regional governments. The problem is that such transfers have introduced additional elements of confusion

into corporate governance, and created conflicting incentives for federal and regional agencies that function both as owners and as regulators. This confusion and the conflicting incentives have been a major obstacle to regulatory reform in all of The Russian Federation natural monopoly sectors (Izaguirre 1998, Martin 1997, Slay and Capelik 1998).

1. How to better regulate natural monopolies: Highlighting some policy lessons and regulatory experiences

The efficiency and behaviour of a monopolistic enterprise, whether private or public, depends much on the framework in which it operates, and especially on the existence of performance-enhancing incentives and penalties (Guislain 1997). We should acknowledge that neither the superior performance of a public monopoly to a private monopoly nor the contrary has ever been proven empirically.

Which specific approaches and techniques need to be applied? This is the crux of the matter of designing natural monopoly regulation policy. In this section, we will highlight and analyze some regulatory practices and experiences of developing and transition economies, so as to draw some policy lessons.

(a) Harnessing competition for regulation as a goal

We observe from the experience of many developing countries that competition is an efficient form of regulation. Where privatization has gone with strong competition in the market, the outcomes were positive, as is the case with Argentine electricity (see Box 1). Thus, whenever possible, harnessing competition in the market for regulation should be the main goal.

(b) Try alternatively 'competition for the market'

If competition in the market is not possible, as eg., in the water industry, one should at least organize the sector so that it can take advantage of opportunities for competitive bidding.

In the water industry, network-related costs are a higher proportion of total costs than in gas, electricity, or telecommunications, and the gains to be made from introducing competition by splitting up ownership of the system are relatively small. Thus, most water will be supplied monopolistically at least for the time being, and franchising appears as a way of encouraging efficiency despite the monopoly (Klein and Irwin 1996). Argentina's positive experience with an international competitive bidding process for Buenos Aires water concession in 1993 is a case in point. In Argentina, water and sanitation competition has been introduced through a bidding process, closely resembling Demsetz-competition (Chisari, Estache, and Romero 1997).

In the railway industry, franchising is also a preferred practice. The success of the early concessions and the lack of credible alternatives have caused a snowballing of such franchise-based reforms in Latin America, spreading also to other regions. So far the experiences in Argentina, Brazil, Chile, Mexico, and Cote d'Ivoire-Burkina Faso are encouraging (see Table 1 again) (Thompson and Budin 1997).

Yet franchising is no panacea. Introducing competition for the market requires *careful* supplementary regulation.

- First of all, it requires a substantial government investment in the *initial* design of the concession. This also entails government's fundamental decision concerning the degree of flexibility of the concession agreements to be allowed (*see Box 2 for some guidelines*). Governments still have to deal with the familiar problem of price regulation. At the time of the concession, the regulator must try to estimate the right price e.g., for water (see the following section 2.3).
- In addition, over the course of the concession, it inherently requires *continuing* government involvement in regulating safety, monopolistic behaviour, and compliance with the pricing and service requirements of the concession. It cannot simply walk away from its concessions once they are completed (Thompson and Budin 1997).

[BOX 1] Importance of ensuring real competition:*Comparative experiences of Chile and Argentina (electric power)*

Argentina is the country that has gone furthest in introducing full competition and vertical disintegration in the electric power industry. Chile is also a path-breaker of privatization in the developing world – alongside Argentina. Yet in the electricity sector, the restructuring of enterprises prior to privatization *fell short of* what was needed to ensure competition. Despite the comparatively advanced Chilean regulatory framework, it could have paid more attention to the property structure, to ensure real competition.

- **Chile:** In the case of electricity, Chile was committed to vertical disintegration, but *to a lesser extent to competition*. In Chile, there were no restrictions on cross-ownership of assets in different segments, unlike Argentina (and Peru), which has prohibited any company or group from controlling more than one of the market segments (e.g., electricity generation, transmission, and distribution). One investment group controls most of the system's generating capacity, the largest distribution company, and the transmission assets. Cross-ownership and consequent conflicts of interest have hindered the development of a more competitive generation market.
- **Argentina:** In Argentina, the power sector was restructured radically in 1992 by unbundling generating, transmission, and distribution activities and organizing them under separate companies. Joskow (1998) describes Argentina's approach to electric power as a "big bang-approach", in which privatization, restructuring, and the introduction of competition were all accomplished in one big step.

Argentina, privatizing much of its power system more than ten years after Chile, benefited greatly from observing that country's problems associated in particular with cross-ownership. Argentina separated monopoly transmission and distribution segments from the competitive generation segment. It adopted a *mandatory* separation principle. No generator is permitted to control more than 10 per cent of the system's capacity, and restrictions on reintegration and cross-ownership are enforced. The resulting diversity in ownership ensured a more competitive environment for generation than in Chile. The restructuring programme in Argentina created a large number of private generating companies, and competition at the generation level has been intense. Transmission and distribution became regulated private monopolies. Retail tariffs are regulated through a price cap mechanism (essentially RPI-X, where RPI is the retail price index and X is productivity gains, with X adjusted after five years). The Argentine privatization has been a clear success in electricity industry.

Source: Bitra and Serra (1994), Chisari, Estache, and Romero (1997), Guislain

(1997), Joskow (1998), Labor and Garcia (1996).

[BOX 2] Designing the initial concession agreements – flexible or inflexible?

(Lessons from Guinea, Cote d'Ivoire, Peru, and Venezuela)

It is not easy to find a balance for each country and each sector between restrictive rules and adoption of a more flexible framework that allows for evolution of the rules but adds uncertainty.

Generally speaking, detailed a priori regulation is better suited to relatively stable, technologically mature, and monopolistic sectors, such as water, than to sectors undergoing rapid technological evolution, such as telecommunications.

However, in developing countries with weak administrative and judicial systems or poor track records concerning credibility, the use of *detailed and relatively inflexible* concession agreements with fairly precise upfront regulation may be preferable to more flexible rules subject to more discretion on the part of the regulator. This may be more likely to reassure investors than the creation of an autonomous regulatory agency with discretionary rulemaking powers.

- **Guinea and Cote d'Ivoire** both opted for the *inflexible* approach in privatizing their water supply and electric power sectors; the leasing contract and concession agreement were accompanied by a detailed schedule of obligations and conditions, leaving few aspects to be decided or agreed upon during execution of the contract. The results are so far encouraging.
- It may be desirable to anchor the regulatory framework securely in a law, which would give it a great stability, *though little flexibility*, as **Peru** did. Peru needed to establish a reputation for credible regulatory rules to attract investment to the sector. The terms and conditions of the initial regulatory contract are enforceable under commercial law, giving the regulator little discretion during the exclusivity period. It has been successful by and large, exceeding all of its major investment and service improvement goals. The regulatory framework, including the terms and conditions of concessioning can be spelled out e.g., as a sector-specific privatization law. This can be particularly useful for governments with low credibility and an inadequate track record, which will usually have to offer more guarantees to attract private investors.

In contrast, the lack of such institutional and legal anchoring probably remains one of the major weaknesses of **Venezuela's** telecommunication franchising. In 1994 relations between CANTV telephone company holding a 35-year concession, on the one hand, and the regulator and government, on the other, became very tense. For political reasons, the regulator blocked the rebalancing of rates and did not meet deadlines to authorize some rate increases provided for in the privatization agreements; one of the quarterly increases was even denied. Even if the short-term effect is not clear, it is likely that this interference will be detrimental to continued private investment.

Source: Joskow (1998), Guislain (1997), Plane (1998).

(a) Regulating monopoly price: Cost-based or price-based formula?

Setting the optimal price for natural monopolies e.g., at the time of the

concession is not an easy matter. Difficulty with monopoly pricing results first of all from the problem of regulators not having access to good information, regarding demand and best practice cost conditions (Bradburd 1992). Secondly, there is difficulty in designing a system of price controls that gives a strong incentive for the regulated firm to invest more and to improve its efficiency.⁸³

Three basic issues are involved:

- the rate level issue—making sure that the total earnings of the firm are appropriately related to the costs;
- the rate structure issue—the determination of the proportion of earnings between different services and different customers; and
- the quality issue, to ensure that price controls do not create incentives for firms to reduce the quality of products and services.

Of the various methods of monopoly pricing regulation, those applied often to concessions in developing countries are described below.

Rate of return (or cost-based) regulation

This ‘cost-plus-fair rate of return’ regulation method (based on *average cost* pricing) allows tariffs to rise subject to a predetermined rate of return. Prices are adjusted so as to keep the company’s rate of return on capital at a constant level. If the company’s rate of return falls below that level, the regulator allows prices to rise. This was popularized in the United States

⁸³ In particular, the main purpose of tariff regulation in most developing countries should be to foster investment rather than to control the level of prices *per se*. In these countries it may indeed be preferable to have relatively high tariffs. An enterprise could then self finance a large part of its investment programme, and contractual or regulatory mechanisms could compel it to reinvest the “excess” tariff in the sector to meet demand (Guislain 1997).

and has been transferred to several developing countries. The telecommunications sector in the Philippines is one example.

Under this approach, the tariff is calculated so as to cover the regulated firms’ operating costs, plus a rate of return on the investment.

The problems with this price regulation method are that:

- One must estimate cost of building capacity. The basis of the calculation may be inflated by means of unrealistic or spurious costs or investments. Under this approach, the utility calculates – and the regulator reviews – the expected operating cost for a normal year (*information problem*);
- It is considered to provide very little incentive for the regulated firm to reduce costs and improve technology. This does not encourage firms to minimize cost, either. It also often encourages to overinvest in capital (*incentive power problem*);
- It is complicated to administer. It requires extensive research into an enterprise’s accounts--and thus plentiful human resources--to determine which costs should be included in the rate base, and which should be disallowed. It requires constant monitoring of management and continual negotiation between the two sides (*regulation cost problem*); and

Its tendency to distort input choices, as well as its administrative difficulties, have made this method of regulation increasingly unpopular. In particular, in most developing countries where professional skills are scarce, the opportunity cost of scarce human capital devoted to regulation is too high to recommend its use (Jones 1994, Klein and Irwin 1996, Yarrow 1994).

**Price
cap (or price-
based)
regulation**

This regulation method tries to avoid these problems. It emerged during the privatization of Britain's utility industries in the United Kingdom in the mid-1980s and is now used in developing public utilities in countries such as Argentina, Brazil (new law on concessions), and Chile.

Under a price cap, prices are allowed to rise by means of a formula, known as RPI-X, that increases the tariff by the increase in the retail price index adjusted by an efficiency factor, X, to account for expected productivity gains and other changes. Under this method, the company has an incentive to lower costs, since it keeps the resulting profits, because it allows the firm to hold on, at least for a designated period, to the profit gains from cost reductions.

The aim of this system is basically to give the regulated firm an automatic incentive to improve productivity, while at the same time enabling consumers to benefit from such improvements through the tariff cuts introduced at times of revision.

Fixing the initial tariff is accompanied by an automatic adjustment rule valid for a given number of years. During an initial period, the advantage of all such gains goes entirely to the concessionaire. In return, any real cost increases are not passed on to the consumer, except in unusual circumstances such as sharply higher purchase prices for energy.

The flexibility and the *relatively* greater ease of administration have made price caps a preferred form of regulation for governments. Price caps allow a company to adjust prices quickly when market or competitive conditions require it, because an extensive review of costs and earnings is not required. Instead, price cap provisions enable a utility to adjust prices as it wishes,

provided the average price for a specified basket of services does not exceed some maximum value (Klein and Irwin 1996, Warrell 1997).

RPI-X price adjustments certainly seem far superior to rate-of-return price adjustments, *but the real difference between them is not as big as it might seem* (Ergas 1994, Jones 1994, Yarrow 1994).

- For example, according to Jones (1994), the incentive power of a monopoly-pricing scheme to induce efficiency does not depend on whether it is couched in cost-plus or RPI-X terms. Rather, it depends on the length of the regulatory lag and the expectations of how prices will be adjusted at the end of the lag. The regulatory lag is the period for which the price is set. The longer the lag, the higher the incentive power of the system. One advantage of RPI-X is then that it is typically associated with a relatively long lag. However, in practice, the point is that this dimension of choice can easily be added to cost-plus schemes. Allowing the price to vary with the rate of inflation promotes a longer lag before prices have to be established. But again, the adjustment can also be accomplished by choosing a price index that relates more specifically to the input price inflation experienced by companies, as seen in Chile (*see Box 3*).
- This price regulation method raises complex issues about the level of the cap, the services to be covered and the monitoring of service quality; hence also imposing a heavy cost in supplementary regulation. For example, RPI-X formulas need to be reviewed every three to five years or so, since the regulator does not know exactly how large X should be and, in reviewing whether X was set appropriately, will take into account the profits being made

by the firm. There is additional trade-off confronting the regulator. Price cap regulation may be good for cost reduction incentives, but may be bad for quality incentives. Incentives for cost-reduction may translate into a tendency to chisel on quality, then leading regulators toward greater involvement in investment and product quality decisions, if not so much concerning the details of tariff formulation.

The challenge for the regulator is then how to balance and reconcile all these different problems such as information requirement and heavy cost of regulation cost. The choice of adequate pricing technique is complex and there is no best case for all circumstances.

The feasible choice for pricing regulation design lies on the continuum between New Zealand and Chilean pricing systems, which define the boundaries of what might be practical. New Zealand's model of extreme simplicity and Chile's model of sophisticated specificity mark the end points of the spectrum of the currently feasible pricing models. Many intermediate solutions are possible between these two models (see Box 3).

A complementary approach is then to use a benchmark or yardstick against which the enterprise measures itself, thus reducing information requirements from the regulated firm. Using yardstick competition can also reduce the undesirable incentive effects of both RPI-X and rate-of-return pricing models (Yarrow 1994, Klein and Irwin 1996).

(a) Getting the relation between privatization and regulation right: A few guidelines

In addition to all these measures of introducing competition, it is equally important that one gets right the privatization sequence and coordination with regulatory reform.

Here are a few guidelines based on the observation of countries' experiences.

- *Implementing related structural and regulatory reforms upfront and prior to privatization is important. The regulatory framework should be as little ambiguous as possible and must be completed prior to privatization.*

-

|

[BOX 3] The two boundaries of possible spectrum of pricing techniques:

New Zealand (minimum) and Chile (maximum)

According to Jones (1994), New Zealand's effort represents the *minimum* that should be done, while Chile's is the *maximum* that should be attempted. Most countries fall somewhere in between, with a relatively long regulatory lag and X set using as much exogenous data as possible. *The precise point on that continuum would then be a function of specific country and industry conditions.*

•New Zealand (model of 'simplicity'):

The system used in New Zealand (described as 'regulation without regulators') is extremely simple. It is based on the RPI-0 pricing mechanism, which is extremely economical in terms of the cost of regulation. Its cost-incentive power is quite high because of the indefinitely long regulatory lag with a fixed price in relation to inflation. The primary emphasis is on cost-efficiency incentives, with considerably weaker controls on the allocative inefficiencies of monopoly pricing. It minimizes the costs of the major regulatory failures, though at the expense of allocative form of market failure.

•Chile (model of 'sophisticated specificity' plus yardstick pricing):

The system can be described as cost-plus-fair-return because firms are allowed a rate of return equal to the risk-free rate plus a premium based on the systematic risk of the industry and the difference between the risk-free rate and the return on a diversified investment portfolio. (It could as well be described as RPI-X because the price cap is adjusted every two months to reflect inflation). Which phrase is chosen is immaterial because the real distinction lies elsewhere. The adjustment period is explicit and reflects a long lag of five years. Moreover, a range of regulatory technology is spelled out in law. In addition to the sophisticated fair-rate-of-return and inflation-adjustment mechanisms, long-run marginal costs are calculated in the context of a five-year investment plan (designed to minimize the system costs of meeting projected demand), markups from marginal to average costs are apportioned via Ramsey pricing, and so on. In addition, Chile used yardstick competition as the local best-practice benchmark as a complementary measure (e.g., in the case of electricity distribution). If the regulator and the firm disagree, they can also appeal to a technical arbitration board. Chile's system has resolved the market failure problem, but at an increased cost of regulation and at the expense of complexity and information requirements.

Source: Jones (1994)

[BOX 4] Using yardstick competition as a ‘complementary’ measure

(Examples: Argentina, Chile, Tanzania)

- Argentina used this technique in several sectors. In addition to introducing competition in the market where it was deemed feasible, Argentines decided also to break up existing monopolies on a geographic basis to create benchmark (or “yardstick”) competition in most infrastructure sectors. In the telecommunications sector, for instance, it was decided that direct competition should not be introduced immediately for basic telephone services previously provided by ENTEL. ENTEL was split between two geographic areas (north and south, with Buenos Aires divided into two zones), served by two separate privatized companies. Although direct competition is (initially) not authorized for basic services, this geographic division allows the regulator and the public to compare the performance of the two companies and exert pressure on the less efficient operator. The same principle was applied to power and gas distribution companies (Guislain 1997, pp. 214-15).
- Another example is the power sector in Chile, where regulators have devised a pricing structure based on the cost structure of an "optimized" distribution firm. Distributors measure their costs against those of the model firm. This method is therefore particularly useful for encouraging efficiency (Nells and Roger 1994, pp. 10-11).
- Tanzania also provides a good example of horizontal unbundling based on geographic location, for cellular services. The regulator has divided the country into four zones and allowed service providers in each. Millicom (Tanzania) Ltd. is licensed to provide service in Dar es Salaam and Zanzibar. TRI Telecommunications Tanzania Ltd. is to provide the coastal (Dar es Salaam) and Northern Zones. Tanzania Telecommunications Company Ltd. is to provide services in Northern, Central and Southern Highland Zones; and MIC Tanzania is providing mobile cellular telecommunication services in the coastal area of the country. This method allows competition by comparison, by forcing each of the regional operators to reveal much data on key areas of their operations (Otoho 1998, pp. 24-25).

Regulatory reform and privatization processes need to be closely coordinated, and their *sequencing* and coordination will have to be thought through from the outset (Bitrain and Serra 1994, Guislain 1997). The privatization of the Argentine telecommunications operator, ENTEL, in 1990 provides a good example of the importance of establishing a regulatory framework *before* privatization proper. Partially due to a conscious decision on the part of the Argentine Government to give priority to a speedy conclusion of the sale, the regulatory regime was not defined until the very end of the

bidding process for ENTEL, following several major modifications during the process itself. This regulatory failure had a negative impact on the telecommunications sector, as shown by the problems with the revision of the tariff formula (UNCTAD 1995, p. 136). There are also other examples such as water privatization in Manila in the period 77-79, which shows the establishment of a clear and effective regulatory framework as a pre-requisite for the success of a natural monopoly privatization programme.

- *The emphasis and priority should thus*

be on the competition-based reform of the sector, rather than on the transactional aspects of the divestiture of one or more individual public enterprises.

Many privatization programmes appear to focus more on revenue generation than on the longer-term gains that more radical restructuring of the enterprise or sector concerned would bring (Guislain *Defining privatization objectives is an important exercise that should be undertaken as early as possible. This is particularly necessary, given the multiplicity and sometimes mutually incompatible nature of the objectives.* An understanding of the possible conflicts between allocative efficiency and other objectives is essential. For example, the sales proceeds to the government may be enhanced by selling a large enterprise as a single entity, whereas restructuring the enterprise into smaller units will improve the competitiveness of the sector and the economy but reduce the proceeds of the sale. Many privatization programmes have floundered when clear objectives were lacking or where conflicting objectives were simultaneously pursued (Guislain 1997, Bradburd 1992, Waddell 1997)

- (a) Dealing with the problem of regulatory capacity: Privatization of regulatory tasks as a solution?

Regulatory capacity is an essential prerequisite for managing privatization and implementing competitive restructuring of natural monopolies.

However, history teaches us that few countries have had the essential capacity to handle a complex regulation policy. Historically, the emergence of municipal ownership of the utilities was due, in part at least, to the lack of confidence in the early regulatory bodies; and one reason for the nationalization of the railways was the failure of the pre-war regulatory system to meet the needs of the industry. More recently, even the relatively sophisticated regulatory agencies, established to control the prices set and the profits earned by the

1997). According to Paddon's study (1998), the privatization practice in Asian public utilities hitherto is generally dominated by gross figures of the overall transactions. In most cases, there is little evidence of specific assessments of a wide range of potential costs or benefits of the privatization of the utility.

industries privatized under the Thatcherite programme in the United Kingdom, have been beset by difficulties, and their decisions have been widely criticized (Ogus 1994).

There are plenty of examples of the fundamental problem with lack of regulatory capacity, which hampered privatization and reform initiatives (e.g., the privatization of Sri Lanka's bus transport, Wanasinghe and Wanasinghe 1991).

Indeed, setting up and choosing the appropriate institutional framework of regulation presents a major challenge for developing and transition economies.

For example, a choice has to be made between multisectoral regulatory agencies (as in Jamaica and Malaysia) and single-sector regulatory agencies (as in Argentina), which created a regulatory agency for each industry. Most experts agree that a multisectoral agency offers advantages over the alternatives. It pools scarce regulatory resources such as regulatory economists and lawyers, especially important in countries with limited regulatory capacity. Also, by pitting interest groups against one another, it obviously tends to increase resistance to regulatory capture and political interference and facilitate a more harmonized approach in different sectors (Estache 1997).

Even so, whether or not a country should adopt one or the other model of regulation should be based on a number of considerations such as the number of operators in the sector; the size of market, the availability of regulatory resources, the complexity of regulatory rules to be monitored and enforced, and the political disposition regarding degree of autonomy for the regulatory agency. This means that the choice of regulatory institutional framework to be adopted should be guided by its good fit with the national context. In general, the larger the economy, the greater the number of operators in the sector or the more complex the regulatory rules for a sector, the greater the need for an independent sector-specific regulatory agency (Otobo 1998).

Additional issues facing governments concern the form of the regulatory body, funding and legal

authority, in particular in connection with the important issue of ensuring effective independent regulation.

The importance of *independent* regulation cannot be stressed too strongly. The experience of the Hungarian electricity sector – where regulatory agencies in 1996 reneged on preprivatization promises guaranteeing foreigners an 8 per cent real dollar return on investments made in 1995 – is instructive in this regard (Slay and Capelik 1998). Even governments with an ambitious privatization initiative like Malaysia could not resist political interference (see Box 5).

An independent regulatory authority is certainly the most attractive solution for investors, as it offers a more stable environment for privatized natural monopoly firms. However, it may not be applicable quickly becomes untenable (Guislain 1997, UNCTAD 1995).

According to Guislain (1997), the problem however lies in the *reality* of many developing and transition economies. In many countries it is difficult to achieve that independence in practice, at least in the short run.

The concept of regulatory bodies independent of the industry and the government is undoubtedly attractive, but independent, autonomous regulatory agencies with decision-making powers may not be suitable for all countries. If the political independence of the regulatory organ cannot be ensured (e.g., as in countries with authoritarian governments), creating a new agency with decision-making powers may needlessly complicate the management of the sector by introducing an additional actor and yet another level of uncertainty. For instance, the United Kingdom model, and in particular the decision-making powers given to individual and independent regulators, should be seen in the proper context: the United Kingdom is a sophisticated industrial country with very strong, well-established legal practices and traditions. In this regard, Guislain recommends for some developing and transition economies with little or no regulatory track record the adoption of a light-handed system of regulation with limited discretionary powers and the contracting out of much of the regulatory control and verification work to

to all countries, particularly in many developing and transition economies where there is no tradition of independent institutions, free from political interference. It is particularly important that the authority be granted an independent source of funding. Independence also requires that, where state-owned enterprises are operating in the sector, the regulatory function be clearly separated from the exercise by the government of its ownership functions. Where sectors were run as public monopolies the confusion from combining operating and regulatory powers in a single entity or person was not uncommon; as a sector starts to open up to new firms, however, this situation

reputable private auditors.

In particular, the idea of a small, central government team that contracts out important regulatory tasks to external auditors and institutions (i.e., '*privatization of the privatization and regulation process*') clearly is an interesting option and deserves some attention. Complex regulatory functions need to be performed professionally; where limited administrative capacity (as seen in the privatization of Sri Lanka's bus transport) is indeed a binding constraint, at least in the short and medium term, 'privatization of regulatory tasks' should be considered. While creation of a separate group or agency with extensive powers and a clear mandate seems to be the best solution, at least for countries with extensive privatization programmes, this option will often be better suited to some other developing and transition economies' administrative capacity.

A. Conclusions and recommendations

Natural monopoly sector privatization is a rapidly evolving field, and it would be premature to venture definitive conclusions as to the "best practice" privatization and regulation models for natural monopolies. Yet, the regulatory experiences in developing and transition economies to date suggest the following preliminary guidelines for natural monopoly regulation policy:

[BOX 5]: Importance of *independent* regulation

The case of Malaysia

Malaysia's ambitious and wide-ranging privatization programme covering railways, the national airlines, telecommunications, electricity and water services attracted considerable domestic and foreign investment. This also allowed the Government to shift to the private sector the considerable cost of improving the country's infrastructure needed to sustain its high economic growth. However, questions have been raised relating to the role of the Government in promoting the healthy development of the privatized utilities. In May 1995, the Government – which retains a 70 per cent share in the privatized electricity utility Tenaga Nasional – decided not to allow Tenaga to raise its prices, thereby contravening a 1993 agreement allowing the utility to adjust its charges according to movements in fuel prices and other costs. The decision was influenced by the Government's concern that higher electricity prices would add to the inflationary pressures in Malaysia's economy. On the other hand, Tenaga defended its proposed price increase on the grounds that an increase in revenues was needed for a multi-million dollar modernization scheme. Many investors now feel that the decision has set an unhealthy precedent for future government interference in the privatized industries. This case illustrates the importance of effective *independent* regulation (UNCTAD 1995).

- ***The bottom line is that regulation is a continuing process, whichever model is used. Harnessing competition for regulation should be the goal, but even the alternative measures of introducing competition (such as Demsetz-competition) require substantial supplementary regulation efforts of government. Embracing the competition principle as much as possible is important. Yet, liberalization requires re-regulation (i.e., reformulation of old rules and the creation of new ones). Again, market liberalization is not the same as ‘deregulation’.***
- ***One should try to take full advantage of the unique opportunity that privatization offers the government to rethink and reform the sector. This implies that one needs to focus more on ‘reform’ based on ‘real’ competition than just the ‘private’ or ‘public’ ownership issue. (Where privatization has involved competitive markets, the outcomes have been positive. As far as the public vs. private ownership debate is concerned, the superiority of neither ownership structure for natural monopolies has ever been proven empirically).***
- ***To this end, countries must find which segments of an industry have competitive characteristics and determine the most suitable ways of introducing more competition, while still maintaining appropriate oversight (e.g., for those sectors that exhibit natural monopoly characteristics. (For example, Demsetz-competition in combination with yardstick competition in the water industry seems so far a feasible way of introducing competition, and vertical unbundling of electricity, hence competition in the market seems both feasible and efficient). This entails that governments still need to deal with the thorny problem of monopoly pricing.***
- ***The price-based (price cap) regulation model appears far superior to the cost-based (rate-of-return) regulation model, e.g., in terms of its incentive power. However, the real difference between them is not as big as it might seem. In practice, the difference becomes often diluted. The feasible choice for pricing regulation design lies rather on the continuum between New Zealand’s model of extreme simplicity and Chile’s model of sophisticated specificity. Many intermediate solutions are possible between these two models, and the precise point on that continuum would then be a function of specific country and industry conditions.***
- ***Countries now also have to grapple more explicitly with distributional impacts, so as to increase the chance of success of competition reform. While it is possible, and perfectly legitimate, to argue that the losses made by some groups are outweighed by the overall gains (according to the so-called ‘compensation principle’), the distributional consequences of competitive restructuring processes (e.g., as a result of ‘economies of density’) then need to be made explicit and at least discussed. Certain distributional inequities are better dealt with by means of subsidies from the government budget.***

- **Not least in this regard, an understanding of the possible conflicts between allocative efficiency and other objectives (including distributional equity objective) is essential. Given the multiplicity and sometimes mutually incompatible nature of the objectives, particularly between static efficiency and dynamic efficiency, clear definition of objectives from the very outset is important. In case of eventual trade-off between static and dynamic efficiency (e.g., when determining the right price level), it is important to keep in mind that the ultimate objective of natural monopoly industries is sufficient and sustainable provision of their services. While reforms may be necessary to make services more efficient and economical (hence increasing static efficiency), the priority should still be dynamic efficiency.**
- **In addition to introducing greater competition, it is also equally important that one gets the privatization process right. In many countries, privatization seems an unavoidable outcome of constraints, particularly financial ones. Once decided for privatization, proper sequencing of the privatization and its coordination with the regulatory reforms are important. The best procedure is that structural and regulatory reforms are implemented upfront and prior to privatization.**
- **It is not easy to find a balance for each country and each sector between restrictive rules and adoption of a more flexible framework that allows for evolution of the rule but adds uncertainty. *Generally speaking*, detailed a priori regulation is better suited to relatively stable, technologically mature, and monopolistic sectors, such as water, than to sectors undergoing rapid technological evolution, such as telecommunications. However, in developing countries with weak administrative and judicial systems or poor track records concerning credibility, the use of *detailed and relatively inflexible* concession agreements with fairly precise upfront regulation may be preferable to more flexible rules subject to more discretion on the part of the regulator. This may be more likely to reassure investors than the creation of an autonomous regulatory agency with discretionary rulemaking powers.**
- **Essentially, there is limited experience with regulation and privatization in developing countries, and we still have much to learn. The choice of regulatory approach is complex and there is no best case for all circumstances. Thus, the choice of particular regulatory framework (e.g.,**

- **between multisectoral and single-sector agencies) to be adopted should be guided by its ‘good fit’, particularly with the particular national context, and reflect the ‘reality’ of developing and**

- **transition economies. In this regard, the option of ‘privatization of the regulatory task’ certainly cannot be dismissed out of hand.**

References

- Baumol, W.J., Panzar, J.C. and Willig, R.D. (1982), *Contestable Markets and the Theory of Industry Structure*, New York: Harcourt Brace Jovanovitch.
- Becker, G. (1997), There's nothing natural about 'natural' monopolies, in: *Business Week*, October 6, 1997.
- Bitra, E. and Serra, P. (1994), Regulatory issues in the privatization of public utilities. The Chilean experience, in: *The Quarterly Review of Economics and Finance*, Vol. 34, Special Issue, Summer 1994, pp. 179-197.
- Bradburd, R. (1992), *Privatization of Natural Monopoly Public Enterprises. The Regulation Issue*, Policy Research Working Papers WPS 864, The World Bank.
- Brauetigam, R. (1989), Optimal policies for natural monopolies, in: R. Schmalensee and R.D. Willig (eds.), *Handbook of Industrial Organization*, Volume II, pp. 1290-1346.
- Chang, H.-J. (1997), Critical survey: The economics and politics of regulation, in: *Cambridge Journal of Economics* 1997, Vol. 21, pp. 703-728.
- Chisari, O., Estache, A. and Romero, C. (1997), The distribution of gains from utility privatization and regulation in Argentina, in: *Public Policy for the Private Sector*, December 1997, pp. 33-36.
- Dnes, A.W. (1995), Franchising and privatization, in: *Public Policy for the Private Sector*, March 1995, pp. 5-8.
- Estache, A. (1997), Designing regulatory institutions for infrastructure – lessons from Argentina, in: *Public Policy for the Private Sector*, June 1997, pp. 13-16.
- Foster, C.D. (1992), *Privatisation, Regulation and the Control of Natural Monopoly*, Oxford: Blackwell.
- Guislain, P. (1997), *The Privatization Challenge: A Strategic, Legal, and Institutional Analysis of International Experience*, The World Bank: Washington, D.C.
- Izaguirre, A.K. (1998), Private participation in the electricity sector - recent trends, in: *Public Policy for the Private Sector*, December 1998, pp. 5-12.
- Jones, L. (1994), Appropriate regulatory technology: The interplay of economic and institutional conditions, in: *Proceedings of the World Bank Annual Conference on Development Economics*, 1993, pp. 181-213.

- Joskow, P. (1998), *Regulatory Priorities for Reforming Infrastructure Sectors in Developing Countries*, The World Bank Annual Bank Conference on Development Economics, April 20 –21, 1998, Washington, D.C.
- Klein, M. and Irwin, T. (1996), Regulation water companies, in: *Public Policy for Private Sector*, March 1996, pp. 5-8.
- Nells, J. and Roger, N. (1994), *The Private Sector Development Seminar: Increasing Private Participation* (<http://www.seas.gwu.edu/student/damenam/telecom/conference/part8.htm>).
- Ogus, A. (1994), *Regulation: Legal Form and Economic Theory*, Clarendon Press: Oxford.
- Otobo, E. E. (1998), Privatization and regulation in Africa: Some key policy issues, in: *DPMN Bulletin*, Vol. V, No. 1, December 1998, pp. 23-28.
- Paddon, M. (1998), Restructuring and privatization of utilities in Asia Pacific region, in: Loretta de Luca (ed.), *Labour and Social Dimensions of Privatization and Restructuring (Public Utilities: Water, Gas, Electricity)*, ILO: Geneva, pp. 43-108.
- Plane, P. (1998), Privatization of water and electricity in Africa, in: Loretta de Luca (ed.), *Labour and Social Dimensions of Privatization and Restructuring (Public Utilities: Water, Gas, Electricity)*, ILO: Geneva, pp. 1-42.
- Schumpeter, J. (1987), *Capitalism, Socialism and Democracy* (6th edition), London: Unwin Paperbacks.
- Sherer, F.M. (1980), *Industrial Market Structure and Economic Performance*, Chicago: Rand McNally.
- Silva, G. and Tynan, N. and Yilmaz, Y. (1998), Private participation in the water and sewerage sector – recent trends, in: *Public Policy for the Private Sector*, September 1998, pp. 41-48.
- Slay, B. and Capelik, V. (1998), Natural monopoly regulation and competition policy in Russia, in: *Antitrust Bulletin*, Spring 1998, pp. 1-17.
- Stiglitz, J.E. (1998), *Knowledge for Development. Economic Science, Economic Policy and Economic Advice*, Address to the World Bank's 10th Annual Bank Conference on Development Economics (ABCDE) (http://www.worldbank.org/html/extdr/extme/js-abcde98/js_abcde98.htm).

Teece, D. (1995), Telecommunications in Transition. Unbundling, Reintegration, and Competition, 1 MICH.TEL.L.REV. 4, 1995
(<http://www.umich.edu/~mttlr/VolOne/Teece.html>).

UNCTAD (1995), *Comparative Experiences with Privatization: Policy insights and Lessons Learned*, United Nations: New York and Geneva.

Vogel, S. (1997), International games with national rules: How regulation shapes competition in 'global' markets, in: *Journal of Public Policy*, Vol. 17, No. 2, pp. 169-193.

Waddell, J. (1997), The Privatization of Monopolies, in: *Economic Perspectives*, Electronic Journals, Vol. 2, No. 1, January 1997
(<http://www.usia.gov/journals/ites/0197/ijee/ej5c4.htm>).

Wanasinghe, S. and Wanasinghe, S. (1991), The return of the private sector to the road passenger transport business: A case study of privatisation of bus transport in Sri Lanka, in: Geeta Gouri (ed.), *Privatisation and Public Enterprise: The Asia-Pacific Experience*, Oxford & IBH Publishing Co.: New Delhi, pp. 407-432.

World Bank (1997), *The State in a Changing World*, The World Bank: Washington, D.C.

Yarrow, G. (1994), The Economics of Regulation, in: V.V. Ramachandran (ed.), *Privatization and After: Monitoring and Regulation*, Routledge: London and New York, pp. 35-46.

XI. ACCOUNTABILITY, TRANSPARENCY AND CORRUPTION IN PRIVATIZATION AND MONOPOLY REGULATION

A. Introduction

In this paper, I will use the following definitions. These all relate to the conduct of *public* business.

- **Accountability** A broad definition covers all the expectations of behaviour from persons in positions of power and authority by those who have placed their trust in them. Accountability in a narrower sense covers behaviour in the use of public *resources* provided by taxpayers, creditors and aid donors. It may be limited to accountability for *financial* results or it can cover accountability for *both financial and operating* results. With reference to privatization, there is a hierarchy of accountability, including the desk officer at operating level, the agency head, the government executive body (Cabinet), the legislature (Assembly) and electorate. Each level is accountable to the next higher level. Where two or more levels are in collusion, sharing economic rents, accountability lies to the next higher level, and so on⁸⁴.
- **Transparency** is also definable broadly or narrowly. Broadly, it means that all stakeholders in public administration can see for themselves how decisions are made—the procedures and criteria used, and can verify for themselves that laws and approved policies are being followed, with no secret agendas or distortions. In the narrower sense, transparency relates to the use of public

⁸⁴ Where a civil service is highly politicized, such collusion is common.

resources and means that stakeholders can see that resources are used as authorized, i.e. transparency is a necessary ingredient of financial accountability⁸⁵. With reference to privatization, each level in the hierarchy of accountability should be fully transparent to the next higher level. The concept is often extended beyond the reporting of public sector finances and includes the reporting of national economic and financial statistics, such as balance of payments statistics. The recent currency crises of Korea, etc. were due, *inter alia*, to a lack of transparency in their external accounts. This is outside the scope of this paper.

- **Corruption (in the public sector)** is widely defined as the use of public office for private gains. As this is always done secretly, it is non-transparent and is excluded from accountability reports. Corruption thrives in the dark. It is inhibited by light. In this paper, we assume that transparency and corruption are at the opposite ends of a see-saw: when one is up, the other is down.

It is sometimes argued that good governance, including honest, transparent and accountable

⁸⁵ Accountability, transparency and corruption draw on the theoretical frameworks provided by organization theory and agency theory, for instance, the study of incentive contracts under moral hazard, and information asymmetry, leading to problems of monitoring and accountability. The work of Rose-Ackerman (1978, 1994) and Klitgaard (1988, 1995) draw on the principal-agent framework.

government, is facilitated by privatization. Any reduction in the size and scope of the public sector correspondingly reduces the area in which public servants may act corruptly⁸⁶.

On the other hand, the privatization *process* is widely seen as a source of corruption:

- “One of the important lessons of the contrast between China and The Russian Federation is for the political economy of privatization and competition. It has proved difficult to prevent corruption and other problems in privatizing monopolies. The huge rents created by privatization will encourage entrepreneurs to try to secure privatized enterprises rather than invest in creating their own firms. In contrast, competition policy often undermines rents and creates incentives for wealth creation. The sequencing of privatization and regulation is also very important. Privatizing a monopoly can create a powerful entrenched interest that undermines the possibility of regulation or competition in the future” (Stiglitz, 1998).
- “In many countries, privatization has been used corruptly by politicians and public officers to sell public assets at low prices to family members and cronies” (UNDP, Second Africa Governance Forum, 1998).
- Privatization has been criticized the world over because people don’t know where the money is going (former Bolivian capitalization minister Alfonso Revollo, in Institutional Investor, January 1998).
- “Privatization in Britain today is a dirty word” (Heath, 1997).

- In the FSU and CEE economies, privatization and corruption have been perceived to be closely linked, though it is argued that corruption is even greater in the non-privatized part of the economy (Kaufmann and Siegelbaum, 1996).

To a lesser degree, business regulation is seen as a source of corruption. Regulators are “captured” by those they should be regulating, leading to higher prices, easier terms of licences and reduced competition.

It is also commonly believed that the increase of global competition accompanying expanding trade and investment in more open markets is making corruption more necessary for businesses to survive and therefore more widespread. “Competitive bribery” is easier than delivering competitive products (Schliefer and Vishny, 1993).

There is a lack of hard data to test any of these beliefs. The extent or trends of corruption in privatization and/or regulation cannot (or cannot yet) be measured, nor the effectiveness of alternative anti-corruption strategies reliably compared for lack of objective and comparable data. Such measures as exist are based on polls of subjective impressions. Moreover, they are omnibus estimates covering not only privatization/regulation-related corruption but many other

⁸⁶ To be sure, a reduction in government productive activity does not imply a reduction in its relations with outside producers. The contrary is more likely. Prager (1992) argues that corruption in contracting out is driven by potential profits from cost savings on substandard work, which would not be sought by an in-house workforce. Secondly, if corporate governance is weak, the private sector may be just as corrupt: transfers of control from the public sector to the private sector may not reduce the deleterious effects overall (Goudie and Stasavage 1997).

fields of corruption, including licence bribery, tax and customs duty evasion, and theft of public property. The corruption indices published annually by Transparency International and similar assessments by sovereign credit rating agencies, for instance, are based mainly on the perceptions of risk analysts and business organizations with respect to the countries with which they have dealings. They are normalized to eliminate overall time trends. These measures are of perceived corruption, not actual corruption, and do not use a constant definition or standard of what is corrupt (Financial Times, 13 August 1997). However, recent work by the World Bank in Albania, Georgia and Latvia indicates that better survey instruments may yield at least lower-bound estimates of corruption (Kaufmann, Pradhan and Ryterman 1998).

This paper, therefore, is not based on any quantitative analysis, but on an a priori analysis of the opportunities for corruption arising out of various modalities of privatization and regulation. The spectrum of privatization modalities includes contracting out, turnkey construction, management contracts, leasing, concessions/build-operate-transfer, partial disinvestment/ joint ventures, and full disinvestment. The latter may be by voucher-based mass privatization, liquidation, public offerings of shares, trade sales, or buy-outs by management and/or employees. Each of these modalities is subject to considerations of how the public interest may diverge from the private interest of new owners, managers or contractors, and of politicians and civil servants, and the necessary corrective measures. *Each form of privatization has its own susceptibility to corruption and its own generic needs for transparency.* After a short review of the impacts of corruption on privatization goals (section 2), the paper examines the opportunities for corruption in the processes of privatization and regulation (sections 3 and 4), and some general strategies of deterrence and detection (section 5). It concludes with some recommendations on anti-corruption action for governments and their consultants (section 6)

|

Types of corruption and impacts on privatization goals

A partial taxonomy of corruption in privatization and regulation would include the following types:

Auction of enterprises	Trade sale of enterprises	Contracting out activities	Regulation of monopoly
	Bribery of official to prefer a particular buyer	Bribery of official to prefer a particular contractor	Bribery to allow or prefer a new entrant
	Bribery to allow lower price and better conditions of sale	Bribery to allow higher price, lower quality, etc.	Bribery to allow higher prices and easier terms and conditions of licence
Collusion amongst bidders	Collusion amongst bidders	Collusion amongst bidders	

This table illustrates the similarity of the three main types of corruption across the spectrum, viz. corrupt preference of person, corrupt preference on terms, and collusion (elimination of competition).

There are always at least three parties affected: the briber, the bribee (public official) and the taxpayers or citizens who lose. Both briber and bribee expect to gain, as in any contract. Even if the initiative comes from the public official (extortioner) rather than from the offeror of a bribe, the extortionee pays only in the expectation that the gain by doing so would be more than his personal loss. The gains of the briber and bribee are the losses of the taxpayers/citizens. *Corruption leads to lower fiscal surplus*, the government officers or politicians involved pocketing a share of the difference between the contract price and the price the buyer would have been prepared to pay, or the minimum price at which the contractor or monopolist would have been prepared to undertake the activity. Schleifer and Vishny (1993) refer to this as “corruption with theft”.

However, the impact is not just a simple financial transfer. There are further losses. There is evidence that corruption, particularly corruption with unpredictable outcomes, increases the cost of investment and slows economic growth (Schliefer and Vishny, 1993, Mauro, 1995, The World Bank 1997, Wei 1997). There is a recent emphasis on the inhibiting effects of corruption on poverty alleviation (Frisch 1996).

There are evident impacts on the relations between citizens and their government. Lack of transparency in privatization may combine with lack of transparency in political funding, and reduce the perceived legitimacy of government.

- **The public is left to draw its own conclusions when seeing those suspected of funding political parties openly benefiting from handsome privatization projects (Lim Kit Siang, New Straits Times, 29 July 1997).**

Corruption can result in reactions which hold up the privatization process. This often arises where Government pressure (or pressure on the government) to complete sales quickly results in cutting corners, a loss of transparency, low prices, and public outcry.

- **In Sri Lanka some enterprises were sold without any form of public advertisement. This resulted in allegations of impropriety and public protests and halted the whole of the programme for a time (Kelegama 1997).**
- **In Kazakhstan, there was only one tender for the Chimkent refinery but the sale was pushed through (The Financial Times, 23 July 1997).**
- **In Malaysia there are calls to slow privatization down and to make it more transparent and competitive (New Straits Times, 6 December 1997).**
- **The first phase of Yemen’s privatization programme, described by an IMF official as one of the most aggressive and rapid he had ever seen, ran into problems of land claims, valuation, labour redundancy and transparency (Middle East Executive Reports, June 1996).**

Corruption reduces investor and donor confidence, which raises the cost of capital and may reduce capital inflows.

- **Financing was lost in Argentina where the World Bank pulled out of further participation in the privatization of the airports because it said the process was not transparent (Feldman 1997).**

- **In Kenya, the IMF suspended disbursement of its structural funding following the court dismissal of the Goldenberg case and lack of transparency in power plant contract awards (Financial Times, 7 July 1997); the Kenya shilling depreciated steeply.**
- **WB and IMF have called on the Government of Malawi, which is committed to a privatization programme, to clamp down on corruption (African Business, March 1998).**
- **In Tunisia the Government plans to sell cement companies which are too large for domestic investors, but foreign investors complain of lack of transparency in the privatization process (The Financial Times, 22 September 1997).**

A. Corruption in privatization

1. Trade sales of enterprises

Sales of enterprises to other enterprises in the industry, local or foreign, is the most common method of privatization, except in the countries which have well-developed capital markets. This is also the method (together with contracting out) which is the most prone to corruption.

Trade sales are not always subject to competitive bidding, whether international competitive bidding, limited international bidding or local competitive bidding. In sub-Saharan Africa, about one third of 1,800 sales of shares or assets between 1980 and 1995 were made without competition (Berg and Berg, 1997). Even if competitive bidding is formally required, corruption opportunities arise in pre-qualification screening and evaluating bids, and in setting the terms of sale of an enterprise. The greater the difference between the price at which an enterprise is offered and its value to the bidder, and the less the risk of discovery and penalty, the greater the incentive for corruption.

While a lot of attention has been paid to improving transparency in government procurement⁸⁷, much less attention has been given to the reverse—government sales. In some developing countries, privatization is not covered by any law or financial regulation, as the possibility of privatization was never envisaged at the time they were formulated. Typically, regulations cover small items like sales of scrap and disposal of obsolete equipment, but not often the sale of going concerns. Similarly, codes of fiscal transparency do not cover privatization as they are more concerned with transparency of overall parameters (expenditures, revenues, etc.) than with individual transactions (Kopits and Craig, 1998, and IMF Code of Good Practices on Fiscal Transparency, 1998).

⁸⁷ UNCITRAL issued a model form of government procurement contract in 1994, and the World Bank has issued nine standard bidding documents, which borrowing governments use for procurement using loan funds, and have tended to adopt for the whole of their procurement programmes. Lately, the WTO has been pushing for liberalization of government procurement by adoption of a Government Procurement Agreement. This became effective from January 1996, but under 30 countries are signatories so far.

In the absence of appropriate privatization regulations, ministries of finance and supreme audit institutions have adopted competitive bidding as the norm. This works much the same way as procurement, except that the highest bid⁸⁸ is accepted instead of the lowest. At least four problems arise:

First, acceptance of the highest bid implies that fiscal return is the sole objective of privatization. On the contrary, many governments expect that buyers will bring in new technology and management and raise efficiency. The trade sale modality is intended to get “a single investor in the driving seat”. In practice, however, the highest bidder may not be the one with the best chance of turning the enterprise around and making it competitive, due to imperfect capital markets (the most efficient buyer not having access to capital). Bids may then be evaluated on additional criteria, such as technical capability and quality of future development plans. These criteria and their weighting in the overall ranking of bids tend to change from time to time and from one privatization to another. They are a lot less objective than the amount bid, and could be used to give improper preferences (INTOSAI 1998: Guideline 17). There may also be criteria of political acceptability, where the wrong people have the money and make the highest bids, eg. foreigners, the *nomenklatura* in Russia, ethnic minority groups in East Africa. These criteria are not usually fully transparent. Nevertheless, competitive bidding is usually the most even-handed and transparent option available (Berg and Berg, 1997).

Second, tender procedures are intended to give all potential purchasers adequate and equal opportunity to make their independent bids, then an award is made to the highest bidder who meets all the prescribed conditions. However, there are many ways in which a tender process can be subverted to ensure that a particular tenderer gets the award, usually by manipulating the bidding conditions or contractual specification so as to exclude certain bidders.

- The procedure may require that tenders be delivered personally, as in the case of the sale of Norilsk Nickel, a mine in the hinterland of Russia. The local airport was strategically closed down to prevent rival bids (Celarier, 1997).

The adoption of *standard sale documentation*, as for government procurement, would go a long way to reducing corrupt manipulations of the pre-qualification, bidding, evaluation and award process.

Transparency International has recommended that potential bidders in a procurement process sign an Integrity Pact under which they pledge to refrain from corruption. Ecuador has experimented with this practice, but it has not been widely used. The difficulty is that it might increase the likelihood of losers challenging the awards, and the resulting costs and delays (Rose-Ackerman, 1998: 35). The same pledging instrument may be applied to disinvestments.

Third, enterprise managers have more information on their enterprises than anyone else and are in a strong position in any competitive bidding situation. They may be tempted to prefer a bidder who gives them private assurances that their services will be retained, or to devalue the prospects of the business in order to discourage bids and sabotage the privatization.

⁸⁸ If the government does not require 100% payment upfront, the bidder's proposed schedule of payments is discounted to its present value, using the cost to the government of incremental public debt as the discounting rate. In such cases, a further criterion of evaluation is the financial standing and creditworthiness of the bidder.

Fourth, even if the tender procedure works as intended, it is often only the starting point for protracted negotiations leading to a final settlement and transfer of the enterprise. This is the point where transparency tends to be lost, as the conditions attached *after* the bids are invited may entirely negate the ranking of bids. Kelegama (1997) cites the case of a company where the purchasers were given a loan by the Government at below commercial rates. This boosted the value of the equity, and presumably would have raised the bids from other buyers if they had known it would be available. More generally, there are many cases of governments modifying the conditions laid down at the point of tender, or giving undertakings as to protection of the company's domestic market, guaranteed sales, or other policy sweeteners. The fact that these negotiations are always carried out behind closed doors does not create public confidence that the best possible deal has been made.

Transparency relates to the terms of *individual* transactions. A simple undertaking to publish the final contract, together with all bids and the criteria of evaluation (as is done in Ghana, for instance, see 5.2 below), would make the process transparent. This may be unpopular with bidders, who frequently get an undertaking from the government that their identity and details of their bids will remain confidential, particularly if they are unsuccessful. However it would have important advantages: first, it would protect the negotiators from charges of impropriety (or alternatively, provide a clear basis for their accountability); second, it would avoid unnecessary suspicions, charges, investigations and delays. Any commercially sensitive data in a bid—future plans for example—could be edited out before publication. The Supreme Audit Institutions should consider if there are any compelling public interest arguments for keeping such details confidential, and may provide the details in a confidential report to Parliament (INTOSAI 1998, Guideline 18).

1. Contracting out

The introduction of competition into the delivery of public services has emerged as a standard privatization technique for all levels of government in several developed countries, where experience has demonstrated that contracting out and managed competition can result in significant cost savings, efficiency improvements and higher quality services. The main problem has always been the corruption of those who award the contracts and monitor performance (Adler 1996).

In developing and transitional countries, the scope for contracting out tends to be limited by the paucity of private firms able to deliver the needed services to the required standards, and by lack of contracting expertise in the government. A well-designed contract bidding and monitoring system is crucial. The bidding system should be designed to encourage competition, protect the agency, and clarify expectations for the winning contractor by explicitly spelling out the service specifications desired. As a rule, the bidding system should be open and competitive. Employees should be prohibited from having any financial interest in the contract and ex-public employees should be prevented from representing contractors before the public agency for a certain period of time. Furthermore, all bid awards should be widely publicized and a record should be kept of the search for contractors.

Also crucial is the design of the monitoring system. Monitoring is the chief means of safeguarding against contracting problems once the contract is signed and of ensuring that citizens are obtaining high quality services at competitive prices. Comprehensive monitoring systems include contractor reports, inspections, and citizen complaints and surveys (Reason Public Policy Institute 1998).

Similar safeguards should apply to the award of contracts for privatization advisory services, which take a large share of privatization proceeds.

2. Public auctions

This method has been widely used in the transitional economies, especially for small enterprises in which the only objective is to maximize the price realized. The most common instances of corruption have been: intimidation of potential bidders to prevent their free participation; collusion (where the potential buyer refrains from bidding in exchange for a fee); default on payment after using the assets; and pre-emptive purchase by persons claiming to have a lease on the assets, with forged documentation. These irregularities led in Slovakia to a tightening up of auction procedures, higher security deposits, and steps to preserve the anonymity of potential bidders. However, few cases of corruption have been brought to the courts and resulted in penalties (Mikloš 1995).

3. Public share offerings

Where privatization is through a public issue of shares or a sale of existing shares to the public, the enterprise must comply with the security laws and regulations of the country. As a public issue is normally accompanied by listing on the stock exchange, the listing requirements of the stock exchange must also be met. Together, these set a high standard of public disclosure, at least as regards the interests of investors.

A public offering is a complex and tightly coordinated process and, like complex trade sales, is usually contracted to an investment bank. This may move the process out of corrupt hands. The choice of bank or other advisor is still subject to corrupt pressures, however.

- The Russian Government dismissed a consortium of investment bankers that had been working on a \$1 billion offering of Rostelcom, the State-owned enterprise for long-distance communications, and passed control to two Russian banks which were acting as both advisers and investors (The Financial Times, 26 November 1996).

In many cases, the initial price of issue has been set low, as evidenced by the immediate jump in price on opening of trading. This has sometimes been taken as evidence of corrupt intent, especially when the allocation of shares favours the biggest investors, but low prices may be due to other factors such as market uncertainty, the political need for a quick sale as evidence that privatization is working, the reduction of the risk of failing, and avoidance of underwriting commission. Where an objective of privatization is broad-based ownership (popular capitalism), a low price, coupled with wide publicity and a preference for small bids, spreads the benefits of ownership widely and reduces the risk of corruption. Where the objective is maximization of revenue, multi-stage flotation or bookbuilding may be used. This also reduces the risk of the politically well-connected cornering the whole issue at a low price.

5. Management and employee buy-outs (MBOs and MEBOs)

There has also been corruption by public enterprise managers using inside information to purchase their PEs on terms which are not in the general interest (Wright and Buck, 1992). MBOs and MEBOs should not be initiated without independent expert valuation of the enterprise as a going concern, ie. taking into account its prospects. If outside bidding is invited so as to establish a valuation, the government has to ensure that bidders get sufficient access to the firm and its records (Mikloš 1995).

6. Voucher privatization

This method, in principle, minimizes the space for corruption. Every bidder has the same number of coupons or points and is free to use them to bid for any of the companies in the pool being privatized. The rules of the game are clear. Corruption is related mainly to the later processes of asset management. There is a risk that the managers of privatization funds, which were insufficiently regulated, run them to their own advantage and at the expense of their shareholders. The risk is at its highest in the transition period between the fund acquiring the shares and the establishment of effective governance of the fund by its shareholders.

- Slovakia's second largest investment fund, PSIPS Banská Bystrica, acquired the vouchers of 190,000 holders by offering each of them Sk 20,000, a sum which it could not have paid if all had required the fund to honour its pledge. It was not until much later that the Finance Ministry launched an enquiry. This revealed excessive fee billing and other irregularities (Mikloš 1995).

1. Spontaneous privatization

A widespread feature of privatization in some of the transitional economies has been the transfer of assets at low prices to the managers of the enterprise or their associates, typically through a new company set up for the purpose, the so-called "spontaneous privatizations". The longer the transition period, from knowledge that an enterprise is to be privatized to the completion of its privatization, the greater the risk.

While there are no statistics in this area, it has been suggested that this continues to be common in the transitional economies and may exceed other methods of privatization in terms of volume (Kaufmann and Siegelbaum, 1996)⁸⁹.

- In Slovakia, a firm called Managerial Consultancy Institute organized workshops and training in 1993 for managers of enterprises on how to transfer their assets to private firms (Mikloš 1995).

In countries with developed property laws, this would be regarded as fraud or theft. Its prevalence indicates the lack of effective laws, cadaster records and enforcement machinery.

D. Corruption in the regulation of monopolies

Each regulatory regime has to be designed to minimize the risk of improper use of regulatory powers and of regulatory capture.

- In Guyana, the Public Utilities Commission was set up to regulate the telecommunication and electricity sectors after the sale of the State telecom utility to a private investor, but was unable to enforce its demands for information. The privatized telecom company was able to bring political pressure on the PUC, which was weakly staffed, to drop its demands and favour the company (Greenidge 1997:115-121).

⁸⁹ Kaufmann and Siegelbaum argue that the level of corruption is correlated with the extent of control rights over enterprises by politicians and bureaucrats (op. cit. p. 430). Against this, the prevalence of corruption by enterprise managers suggests that it is the latter who exercise effective control (in terms of disposition of enterprise assets on terms advantageous to themselves). After privatization, managers may still act corruptly against the new owners. The problem is one of corporate governance rather than ownership per se.

- **In the United States, the regulatory body set up to protect consumer interests in civil aviation came in time to operate as a cartel on behalf of the established carriers. Similar tendencies exist in transport throughout the world (Kay and Vickers, 1990: 232)**

Over the last 15 years, studies show that reforms to the regulatory system have been much less complete and productive than macroeconomic reforms, particularly in Latin America. Reforms in regulation are overdue (De Assis, Kaufmann and Langseth, 1998). One problem is what has been termed “competitive deregulation”. Jurisdictions seeking to attract investment relax their regulations and enhance secrecy provisions. This facilitates money laundering and reduces the effectiveness of international cooperation against corruption.

Transparency in monopoly regulation is concerned with ensuring a free flow of accurate, relevant and up-to-date information to all stakeholders. To avoid charges of irregularity, regulators should make their decisions on the basis of representations by the interested parties and publicly available evidence. There should also be right of appeal to an independent judicial authority (Ros, 1997).

Governments improve the quality of information and strengthen the hand of the regulator by breaking up a monolithic enterprise into regional parts, prescribing a common standard of reporting for all the regional entities and applying benchmark competition to their performance figures. For instance, in the privatization of the Manila Waterworks and Sewerage Service, the area was split into two zones and sold separately. The regulator will be able to compare the operating and capital costs of the two zones line by line. This has generally worked well, eg. in the United Kingdom, but is still subject to the possibility of collusion between regulatees.

Monopoly regulation in the UK depends primarily on the regulators, who are nominally independent of both enterprises and the Government. However, the regulators are themselves regulated (or at least monitored) by consumer groups who suspect that consumer interests may be sacrificed to the benefit of the shareholders. Regulators may allow utilities to withhold information on grounds of commercial confidentiality, but consumer groups say that the greater problem may be that sufficient information is not asked for. The problem is increasing with the trend to multi-utilities: their regulation needs more information, and it is more difficult to reconcile the accounts for each regulated market with the overall group accounts. Another complication is that the price cap depends on the capital expenditure projected by the enterprise and allowed by the regulator (Dee and Meek 1997). A green paper on utility regulation in the United Kingdom, published in March 1998, aims to make consumers the main priority and to improve transparency, consistency and accountability. Regulators will be required for the first time to publish reasons for their decisions (The Guardian, 26 March 1998).

In monopoly regulation, boards are more often preferred to single regulators in order to reduce the burden of individual accountability and discretionary opportunities for corrupt practices. In many countries, the corruption issue is very serious and regulatory regimes must be designed to keep regulatory discretion to a minimum, e.g. by relying more on potential competition, by making regulations very simple and automatic, and making regulatory decisions transparent (reasons to be given) and justiciable. Similarly, multi-sectoral agencies are preferred to single-sector agencies as they are stronger and more resistant to capture.

E. General strategies of deterring and detecting corruption

1. **Clarity in relevant laws, policies and procedures**

Privatization rests on property rights. Most of the transitional economies have passed laws to establish and protect property and contract rights. However, there are many gaps, and the judiciary is not yet fully trained in their application.

- In Russian Federation, for instance, investors are not issued with share certificates as evidence of ownership: disgruntled managers need only cross out the name on the share register. The legal enforcement void has been filled by the worst sort of alternative dispute resolution mechanism—resolution by gangsters (Celarier 1997: 535).

In other countries, such as the Asian tigers, formal legal systems took a long time to develop, but informal institutions and social norms served to lower transaction costs and provide an acceptable framework.

Complexity and ambiguity in the privatization and regulatory framework lead to administrative discretion in its application. This has been identified as a prime source of corruption. If laws, regulations and procedures are clear and fully specified, there is less room for corruption, as politicians and bureaucrats have no grounds for discretion or delay, and less flexibility in interpreting regulations, etc. to their own advantage. The rules of the game should therefore be public. On the other hand, administrative efficiency is increased by the “new public management”, which allows the public officer greater flexibility in the *means* of achieving better performance in exchange for commitments to higher targets. There are trade-offs between corruption and flexibility which need to be explored in each situation.

A further source of corruption is the number of persons involved or signatures required in the relevant procedure for a transaction. Each separate approval by an official (who has a monopoly of that function) constitutes a rent-collecting opportunity. If the number of officials involved in a single transaction is unnecessarily increased, far from providing an internal check, this may instead provide more opportunities for corruption and dilute accountability, as well as slow the process down. Procedures should be simplified to make fewer officials more responsible; decision criteria should be more clear, known to all parties and less discretionary in their application.

In some cases, it may be possible to destroy bureaucratic monopolies by providing alternative service points to the public, or overlapping service jurisdictions as recommended by Rose-Ackerman (1994). In the context of disinvestment, however, it would not be practicable to have more than one agency with the authority to dispose of each individual enterprise, but it might be practicable to separate authority to evaluate bids and name the winner from the authority to negotiate the contract of sale..

Most countries make bribery of public officers a criminal offence. Extortion, where an official demands a private benefit, is also usually defined in national criminal codes. Prosecution under the law of fraud may be preferred where it is difficult to prove corrupt intent. In some countries the laws need to be clarified and extended to cover bribery committed in a foreign country. Other loopholes have to be closed. There are international model laws for this. Alternatively, civil action may be taken by a losing bidder to set aside a corrupt contract under competition laws, such as anti-trust or restrictive business practice regulations. Prosecutions may also be brought under regulations covering foreign exchange, or under the tax laws (given that income from corrupt activities is not declared).

- The lack of a clear competition law in the Philippines has proved commercially damaging, as losers in privatization bids go to the courts and obstruct business (The Financial Times, 17 April 1997). The

judiciary's powers of review under the 1987 constitution are so broad and ill-defined that anything can happen (The Financial Times, 3 December 1997).

- In Kazakhstan, the law on privatization is only four pages and leaves a lot of gaps. If a firm wins a tender, it must sign a contract with the Government within ten days, but there is no explanation of what happens if this is not done in time. Thus the tender can be set on one side at the option of the Government. A contract to buy two power stations in Pavlodar was revoked and given to another company which had not participated in the tender (The Financial Times, 23 July 1997).

It is commonly argued that corruption raises the cost of doing business and makes outcomes less certain. However, the latter is not always true. A corrupt politician with a fixed 10 per cent rule may be very predictable.

- “If you can't pay off somebody, then that creates uncertainty. You put in an honest bureaucrat, and that creates uncertainty” (Tariq Banuri, Director of a think tank in Pakistan, quoted in Far Eastern Economic Review, 26 September 1996).

Regulations should be at least as predictable in their application.

1. Disclosure of transaction details and results

In many countries, privatization is so politically sensitive that traditional civil service secrecy is intensified.

- In Malaysia, a lot of things are kept hidden on the grounds that they come under the Official Secrets Act (President, Malaysian Medical Association, reported in New Straits Times, 18 June 1996; see also Jomo 1995: 57-8).

Even after a privatization is completed, the public may not be informed and it is left to those who lose by the process to bring it to the general attention. Good governance requires a very different approach. Decisions on the operation of tenders, award of contracts, licences and franchises, the allocation of shares, etc. should be open to the public (Muzaffar 1997).

- In Ghana, the Divestiture Implementation Committee (DIC) came under intense criticism in 1993 from the general public for lack of transparency in its operations. The criticism was accepted and the DIC started publication of vital pieces of information such as its procedures, the names of all PEs sold, their purchasers, the price in each case, and details of what was paid upfront and the balance outstanding. The actual privatization activities were contracted out to private accounting, banking and law firms, leaving supervision to the DIC (Dzakpasu, 1998).
- In Tanzania, the bidding procedures, criteria and results are subject to publication (Presidential Parastatal Sector Reform Commission, 1993)

A few countries have opened themselves up to their constituents. In the United States, the Freedom of Information Act (FOIA) of 1974 substituted the “right-to-know” standard for the “need to know”. It applies to all Federal executive government agencies. An agency can refuse to release a requested record or part of a record *only* if it falls within any of nine statutory exemptions, such as documents classified on grounds of national defence or foreign policy, tax returns and other such documents prohibited from release, confidential business information, information which could undermine crime prevention or prosecution, and

communications between departments where the related decisions have not yet been made. The FOIA has been widely used and has had a significant impact in making Federal government more open and transparent. It has also given rise to a complex body of law. Similar legislation exists or is in the pipeline in Australia, Canada and the United Kingdom.

The exemption of documentation *preceding* a decision implies that the privatization process may still be kept under wraps up to the moment of decision. Critical decisions are: (1) whether a given enterprise or activity is to be privatized, (2) to whom an enterprise is to be sold or activity contracted, and (3) the terms and conditions of the contract or regulatory licence.

By the same token, the public has a right to know whether the Government's objectives in privatization and regulation are being achieved. Unfortunately, few governments sponsor any systematic and independent evaluation of the impact on efficiency, equity, investment, fiscal balance or any other relevant criteria. Where they do, the evaluation is conducted internally, often by those involved in the process and who have an interest in showing that all is going well, and the results are not published. Independent evaluation of impacts should be encouraged, with feed-back to policy-makers and other stakeholders.

1. Public complaints, whistle blowing, hotlines

If there is a clear statement of policy goals, laws and procedures, this provides a standard on which aggrieved citizens, such as bidders who have been improperly discriminated against, can base their claims of irregularity. It is then necessary to ensure that the standard is widely known and accessible, eg. through policy statements and public communication campaigns, and that there are channels for citizens' complaints, including anonymous complaints. The capacity and independence of the media to investigate and disclose impropriety in Government operations should be promoted as this is a major deterrent to corruption as well as a source of information in rooting it out.

Governments rely considerably on contractors, suppliers and citizen groups to report on particular cases of corruption, since they are the losers and have the most to gain from challenging fraudulent contracts. Rose-Ackerman (1994) has proposed an international forum to review cases of suspected corruption in privatization or contracting cases brought by disappointed bidders. If the terms of a deal diverged significantly from what would have been expected in an honest process, the sale would be rebid. The jurisdiction of the tribunal would be limited to countries that voluntarily establish an Integrity Pact in return for technical assistance.

Strong business and professional associations can discipline their members and help them resist bribes. Self-regulating associations can set and enforce ethical standards (Cooter 1997). The level of corruption in a country is linked to its cultural and social norms and may be reduced by changes in those norms, eg. by strong leadership.

2. Independent watchdog agencies

Audit offices, anti-corruption agencies, ombudsman offices and ad hoc commissions of enquiry are vital constitutional checks on corruption. In some countries, however, they have limited independence and cannot pursue investigations where ministers or powerful bureaucrats are involved. In many countries, audit offices are still struggling with inadequate staff to extend the coverage and effectiveness of simple regularity audit: this has led to donors instituting their own accountability regimes with respect to aid disbursements.

All these agencies should have powers which go beyond access to records and books of account. Bribes do not show up in the official books of a government agency, and are not revealed by conventional audit checks, so auditors and investigators have to be more enterprising in their methods. The audit of privatization requires non-traditional skills. Supreme audit institutions (SAIs) should consider using outside specialists, even on long-term contracts to cover the likely period of a privatization programme.

The INTOSAI Working Group on Privatization has issued guidelines saying that an SAI should become involved in the privatization process as soon as constitutionally possible consistent with maintaining its independence. Then it should examine whether adequate safeguards are in place to ensure that a sale is properly and honestly carried out. They suggest that all parties to a transaction should know that the sale may be the subject of an independent and searching examination by the SAI, and that its findings are likely to be published in the public interest. The time factor is important as it is likely that many of the key people involved in the process will disperse soon after it is completed (INTOSAI 1998).

3. Independent administration/monitoring

Where a new specialized body is set up for a limited period to run a privatization programme, and particularly where the ownership of enterprises selected for privatization is transferred to the new body, it breaks the established patronage controls and sends a signal that the rules of the game have changed. Provided the managers of the new body are not merely a front for the former owners, this organizational strategy may set the scene for transparent management planning and monitoring systems, as in the case of the Truehand in Germany (Kaufmann and Siegelbaum 1996).

Since technical capacity is often scarce, governments have hired consultants. In Morocco, for instance, international accounting firms have participated actively in the audit and evaluation process so as to promote transparency (Ministry of Privatization and State Enterprises, 1996).

In some cases, consultants have had more than advisory roles, and have been contracted to run the programme, as in Bulgaria. The danger of this insulation from the political process, however, is the lack of political accountability of the consulting firm (Alexieva and others 1998).

In rare cases, governments have allowed external bodies to supervise individual privatizations. This compares with external surveillance of domestic elections. The privatization of the Manila water and sewerage system, which was supervised by the International Finance Corporation, was praised for its transparency and speed (Khalili 1997).

4. Civil service codes of conduct and statements of assets by political leaders and high-ranking officials

Some countries have passed laws requiring holders of certain offices to report their private assets at regular intervals, either to a special agency which keeps the data private but is empowered to investigate unexplained accretions in wealth, or to the public. The laws are not always effectively applied, however.

- In Pakistan, Senators and Members of the Provincial and National Assemblies furnish annual statements of assets. However, there is no penalty for non-compliance (Dawn Wire Service, 31 October 1996).

Written codes of ethics and integrity training for civil servants raise awareness of ethical issues in government operations, and help to establish and strengthen norms of ethical conduct. The UN published a model code of

conduct with the General Assembly resolution 51/59 of January 1997⁹⁰. At the Second Pan-African Conference of Ministers of the Public Service, held in Rabat in December 1998, participants considered that enhancement of ethical standards and integrity systems is a key issue for the development of the region, and recommended that each country reform its civil service code, stressing ethics and integrity. A code of conduct for African public servants is being drawn up⁹¹. Also there are proposals for a code of conduct for public officials in financial administration⁹².

Corruption is often said to be due to low pay of public officials. Their real pay in many countries is so low that they have to take bribes in order to make ends meet, it is argued. Countries which pay their officials well, such as Singapore, tend to have low bribery rankings. This argument applies more to petty day-to-day corruption, and less to low-incidence high-value privatization transactions.

7. Anti-corruption initiatives by foreign governments and intergovernmental agencies

Though the focus of this paper is on developing and transitional economies, it should be clear that a large part of corruption derives from cross-border transactions between developed country businesspeople and developing/transitional country officials.⁹³ Corruption has become increasingly a transnational phenomenon, driven by globalization and requiring supranational and global responses.

The Foreign Corrupt Practices Act of the US, enacted in 1977, made corrupt acts by US businessmen with regard to foreign governments a criminal offence. Though prosecutions are few and there are many loopholes (Economist, 16 January 1999), it is believed to have reduced bribery by American corporations to a significant extent (Johnston, 1998).

Also in 1977, the International Chamber of Commerce designed a set of rules to combat extortion and bribery. Since then, several governments and international organizations, in particular the United Nations, The World Trade Organization, The World Bank, The United Nations Development Programme, The International Monetary Fund, The Organization for Economic Cooperation and Development, The Council of Europe, The European Union, The European Bank for Reconstruction and Development, The Asia-Pacific Economic Forum and the Organization of American States have taken up the challenge. (See the Annex to this paper for a summary of the main initiatives from these bodies).

In some developed countries, assisting in money-laundering has been made a criminal offence. There are two major problems. The prosecutor's difficulty is in proving that the person assisting in money laundering knew or suspected the illegal origins of the cash. In the United Kingdom, for instance, regulations under the 1993 Criminal Justice Act apply a "reasonable care" test to financial advisers and bankers. They must "know their clients". All suspicious transactions must be reported to the National Criminal Intelligence Service (Accountancy Age, 12 February 1998). Secondly, there is a temptation for other countries to build themselves up as financial centres by turning a blind eye to the sources of inflows. Financial havens spoil the efforts of all countries in reducing corruption by making it easier to hide the proceeds. Internationally-accepted standards in this area would be a major global public good (The Economist, 26 July 1997).

⁹⁰ Reproduced in UNDP (1998)

⁹¹ Rabat Declaration, 15 December 1998. UN Department of Economic and Social Affairs and CAFRAD.

⁹² Draft proposals for a code of conduct for financial administration, UN-DESA, November 1998.

⁹³ Transparency International is developing an index of bribery propensity among leading exporting nations.

A. Conclusion

Relatively little empirical work has been done on accountability, transparency and corruption in the area of privatization and regulation, despite its high profile in international and national developmental agendas, and the evidence is anecdotal. It is widely believed (though not objectively verified) that corruption in the implementation of privatization programmes has been a major hindrance in the realization of the potential benefits. This is associated with the lag in development of effective regulation of private operators in a privatized environment.

There are no recent guidelines on how to corruption-proof each of the major modalities of privatization or regulation⁹⁴. In particular, there has been little attention to accountability and transparency guidelines in government sales of enterprises. It is suggested that this gap could be filled by drawing up generic guidelines on procedures and standard documentation, based on existing standards for government procurement, and their adaptation and adoption in countries, particularly those in receipt of loans and technical assistance. However, their effectiveness would depend mainly on individual government leaders and their ethics enforcement agencies.

The most direct improvement in transparency may be gained by the routine public disclosure of details on each major privatization, including bids, scoring systems for multiple criteria, ranking of bids, and final contracts. Exemptions from disclosure, such as commercially confidential data, should be pre-defined, as in the freedom-of-information legislation in some countries. The onus should be on the government to prove that any data not disclosed is done so in the public interest.

General strategies of improving accountability and transparency include:

- Reduction of administrative discretion, even at the cost of reduced flexibility, efficiency or equity. The rules of the game should be made public;
- Watchdog agencies should be strengthened and made independent of the executive and the judiciary;
- Privatization programmes should be taken out of the hands of line ministries and managed by expert agencies which use external consultants as necessary, but remain politically accountable; and
- Civil service codes of conduct, including regular statements of assets, should be introduced and made effective, with sanctions for non-compliance. This would be assisted by greater international action against money laundering, and controls on financial havens.

⁹⁴ The main source is still Vuylsteke, 1988, but this is not oriented to transparency or avoidance of corruption.

Annex

Corruption has long been on the agenda of the United Nations through the regular meetings of the International Conference Against Corruption, the work of the UN Office for Drug Control and Crime Prevention, and the public administration and finance programme of technical assistance of the Department of Economic and Social Affairs and its predecessors. The UN General Assembly adopted a resolution 51/59 in December 1996 articulating its stance against corruption and adopted an *International Code of Conduct for Public Officials*. A further resolution 51/191, adopted the UN Declaration against Bribery and Corruption in International Commercial Transactions. Currently, the UN Centre for International Crime Prevention, Vienna, is putting together a network of international and regional agencies which are involved in anti-corruption activities, to be called the Global Programme Against Corruption. Other agencies involved include the UN Office for Drug Control and Crime Prevention, the UN Interregional Crime and Justice Research Institute, the World Bank, the UNDP Programme on Accountability and Transparency, Transparency International, the USAID, the Commonwealth Secretariat, and the UN Department of Economic and Social Affairs. UN-DESA provides the secretariat to intergovernmental bodies such as the Economic and Social Council, and helps to build awareness of the corrosive impacts of corruption and measures to combat it.

Corruption remains a major obstacle to trade. International trade should meet minimum standards of transparency. However, trade policy is already tied to a range of social, environmental and other issues, and there is strong resistance to further constraints. Within the WTO, the Agreement on Government Procurement entered into force on 1 January 1996, but only a few countries so far, mainly developed countries, have adopted its provisions (see section 3.1 above).

- Taiwan is privatizing its telecommunications and making its procurement processes more transparent. According to US officials, this is to position the country for WTO membership (East Asian Executive Reports, 15 May 1997).

The World Bank and regional banks are tightening up their procurement rules on the use of loans and providing technical assistance to anti-corruption programmes, particularly the strengthening of public sector accounting, audit and procurement systems, since transparency is now seen as crucial to its mandate of promoting economic development. The Economic Development Institute, together with Transparency International, is assisting countries run integrity workshops with broad participation by State and civil agencies. These workshops raise awareness of corruption and its impacts, and strengthen institutions in preventing and prosecuting acts of corruption. However, their effectiveness depends largely on actions and behaviour by the leadership⁹⁵.

The IMF has tied its financial assistance to “good governance practices”. Traditional country reviews of inflation, trade, tax and market reforms now include assessments of governance issues, including corruption and transparency. The IMF has issued a Code of Good Practices on Fiscal Transparency and a supporting Manual (IMF 1998), but it has left the good practices on privatization procedures to the World Bank (1988) and on transaction transparency to INTOSAI (1998).

⁹⁵ A ruler who is not himself wise cannot be given good advice (Machiavelli).

Recently, the OECD has promulgated a Convention on Combating Bribery of Foreign Public Officials in International Business Transactions. The Convention was signed in May 1997 by 34 countries (all OECD countries and 5 others) and comes into effect in February 1999, subject to ratification by signatory governments⁹⁶. It makes payments to public officials to influence decisions (ranging from government procurement contracts and infrastructure projects to privatization tenders) a criminal offence. It also calls on governments to end the tax deductibility of bribes⁹⁷. With respect to privatization, the Convention affects only sales to foreigners, not to domestic investors. Thus, all OECD countries are now in line with US and compete for privatization and other contracts and are subject to domestic regulation on an equal basis. In addition, the OECD is setting up an Anti-Corruption Network for Transition Economies (www.afr-sd.org/acn).

⁹⁶ The Economist (16 January 1999) reported that only 12 countries have ratified it so far.

⁹⁷ About a dozen members of OECD still encourage the corruption of foreign government officials by allowing their own businesses to count bribes as business expenses in calculating their taxable income.

References

- Adler, Moshe (1996) In city services, privatize and beware, in *New York Times* 7 April 1996.
- Alexieva, N., John Nellis, T. O'Brien and Lada Stoyanova (1998) A Review of Bulgarian Privatization, Paris: OECD. Paper tabled at a seminar on Bulgarian enterprise privatization, progress and issues, November.
- Berg, Andrew and Elliot Berg (1997) Methods of privatization, in *Journal of International Affairs*, 50/2, Winter, Columbia University.
- Celarier, Michelle (1997) Privatization: a case study in corruption, in *Journal of International Affairs*, Winter, 50, no.2 The Trustees of Columbia University in the City of New York.
- Cooter, Robert D. (1997) The role of State law versus the rule-of-law State: economic analysis of the legal foundations of development, in *Proceedings of the annual World Bank Conference on Development Economics, 1996*, Washington D.C.: The World Bank.
- David, I.T. (1988) *Privatization in America, Municipal Yearbook* Washington D.C.: International City Management Association.
- De Assis, Kaufmann and Langseth (1998), Integrating Institutional Reforms into an Integrity System, Paper presented to the PACT Workshop, Bangkok, June.
- Dee, Sharon and Colin Meek (1997) Secrecy and the UK utilities, in *Consumer Policy Review*, 7/4, pp/118-123, July/August, London.
- Dzakpasu, Cornelius (1998) *Privatization and management development in Africa*. ILO, Geneva.
- Feldman, Joan M. (1997) Airports for sale, in *Air Transport World*, New York: Penton Publishing.
- Frisch, Dieter (1996) The effects of corruption on development, in *Courier* 158 (July-August): 68-70.
- Goudie, Andrew W. and David Stasavage (1997) *Corruption: the Issues*, OECD Development Centre Technical Paper No.122.
- Greenidge, Carl (1997) Political economy of privatization in Guyana, in Anthony Bennett (ed.) *How Does Privatization Work?* London: Routledge.
- Heath, John (1997) Privatization in perspective, in Anthony Bennett (ed.) *How Does Privatization Work?* London: Routledge.
- IMF (1998) Code of Good Practices on Fiscal Transparency, available on website www.imf.org/fiscal/maual/toc.htm .
- INTOSAI (1998) Guidelines on best practice for the audit of privatisations, draft by the Working Group on the Audit of Privatisation, International Association of Supreme Audit Institutions (available at www.intosai.magnet.at).
- Johnston, M. (1998) Cross-border corruption: points of vulnerability and challenges for reform, in *Corruption and Integrity Improvement Initiatives in Developing Countries*, UNDP Programme in Accountability and Transparency, New York, and OECD Development Centre, Paris.

- Jomo, K.S. (ed.) (1995) *Privatizing Malaysia: Rents, Rhetoric, Realities*, Boulder, Col: Westview Press.
- Kaufmann, Daniel and Paul Siegelbaum (1996) Privatization and corruption in transition economies, in *Journal of International Affairs*, Winter, 50/2, Trustees of Columbia University in the City of New York.
- Kaufmann, Daniel, Sanjay Pradhan and Randi Ryterman (1998) New frontiers in diagnosing and combating corruption, in *Public Management Forum*, IV/6, Nov/Dec. Paris: Sigma/OECD.
- Kay, John and John Vickers (1990) Regulatory reform: an appraisal, in Giandomenico Majone (Ed.) *Deregulation or Re-Regulation: Regulatory Reform in Europe and the United States*, London: Pinter.
- Kelegama, Saman (1997) Privatization in Sri Lanka: an overview, in Anthony Bennett (ed.) *How Does Privatization Work?* London: Routledge.
- Khalili, Sara (1997) Industry leaders, in *Infrastructure Finance*, Vol.6 No.7, pp.87-92.
- Klitgaard, R. (1988) *Controlling Corruption*, Berkeley: University of Columbia Press.
- Klitgaard, R. (1995) National and international strategies for reducing corruption, paper presented to the OECD Symposium on Corruption and Good Governance, Paris.
- Kopits, George and Jon Craig (1998) *Transparency in government operations*, IMF Occasional Paper 158, January.
- Mauro, Paolo (1995) Corruption and growth, in *Quarterly Journal of Economics* CX(2), No.441.
- Mikloš, Ivan (1995) Corruption risks in the privatization process: a study of privatization developments in the Slovak Republic focusing on the causes and implications of corruption risks, Windsor Group, Bratislava (www.mesa10.sk/privat/corrupt.htm).
- Ministry of Privatisation and State Enterprises, Government of Morocco (1996) *Guide to Morocco's Privatization Programme*, October.
- Muzaffar, Chandra (1997) Establishing a fully moral and ethical society, paper delivered at the National Vision 2020 Congress, Malaysia.
- Prager, Jonas (1992) Contracting-out: theory and policy, in *Journal of International Law and Politics*, 25/1, Fall, New York University.
- Presidential Parastatal Sector Reform Commission, United Republic of Tanzania (1993) *Parastatal Privatisation and Reform Master Plan*, Dar-es-Salaam.
- Reason Public Policy Institute (1998) *Designing an Effective Bidding and Monitoring System to Minimize Problems in Competitive Contracting*, Los Angeles: RPPI.
- Ros, Agustin J. (1997) When, where and how? Implementing effective telecommunications competition and regulatory policy, in *Journal of Project Finance*, Winter, Vol. 3, No.4, New York.
- Rose-Ackerman, S. (1978) *Corruption: a Study in Political Economy*, New York: Academic Press.

Rose-Ackerman, S. (1994) Reducing bribery in the public sector, in Duc V. Trange (Ed.) *Corruption and Democracy: Political Institutions, Processes and Corruption in Transition States in East-Central Europe and in the Former Soviet Union*, Budapest: Institute for Constitutional and Legislative Policy.

Rose-Ackerman, S. (1998) Corruption and the global

economy, in *Corruption and Integrity Improvement Initiatives in Developing Countries*, New York: UNDP and Paris: OECD.

Schliefer, A. and R. Vishny (1993) Corruption, in *Quarterly Journal of Economics*, 108/3.

Van Rijckeghem, Caroline and Beatrice Weder (1997) *Corruption and the Rate of Temptation: Do Low Wages in the Civil Service Cause Corruption?* IMF Staff Working Paper, May.

Vuylsteke, Charles (1988) *Techniques of Privatization of State-Owned Enterprises*, Volume 1, Methods and Implementation, World Bank Technical Paper No.88, Washington: The World Bank.

Wei, Shang-Jin (1997) How taxing is corruption on international investors? Cambridge, MA: Harvard University, Kennedy School of Government, mimeo.

Stiglitz, Joseph (1998) More instruments and broader goals: moving toward the post-Washington consensus. The 1998 WIDER lecture, Helsinki, 7 January (available at www.worldbank.org/html/extdr/extme/js-010798/wider.htm)

UN Department of Technical Cooperation for Development (1989), *Corruption in Government*, TCD/SEM.90/2, INT-89-R56. New York: United Nations.

UNDP and OECD (1998) *Corruption and Integrity Improvement Initiatives in Developing Countries*, New York: UNDP and Paris: OECD Development Centre.

World Bank (1997) *World Development Report*, Washington DC: The World Bank

Wright, Mike and Trevor Buck, Employee buy-outs and privatization: issues and implications for LDCs and post-communist countries of United Kingdom experience, in *Public Administration and Development*, Vol.12, 1992, pp.279-296.

**XII. INTERNATIONAL COOPERATION IN PRIVATIZATION PROGRAMME AND
POLICY MANAGEMENT**

A. Introduction

The world and its international and national agencies have come to recognize that enterprises are key actors in the development process. They are the major driving forces behind the inter-related flows of trade, investment and technology. It is on them that the strength and dynamism of the economy depends. For that reason, national governments have a major interest in promoting enterprise efficiency. Such efficiency can bring important dividends in terms of increased productivity, investment, growth, employment, trade and fiscal benefits. This drive for efficiency is done through reform of the enterprise, and especially through privatization. In the last fifteen years privatization has transformed several thousand outdated, loss-making state operations into robust and profitable private enterprises.

Some statistical background drawn from The World Bank data can demonstrate how privatization has become increasingly popular in *developing countries* over the past 10 years. (These figures are drawn from two studies¹ reported in *Economic Reform Today*, a publication of the Centre for International Private Enterprise in Washington, DC.)

- In the period 1988-95, 88 countries sold \$135 billion worth of assets in 3,801 transactions of more than \$50,000.
- In 1992 alone, completed privatizations in developing countries raised \$23.1 billion.
- The number of countries with active programs of privatization rose from 12 in 1988 to 43 in 1995.
- The value of the sales achieved in the privatizing countries represents on average 0.5 % of the nation's gross domestic product (GDP).
- Latin America and the Caribbean was the leading privatizing region, with total sales of almost \$54 billion or 46 percent of the total world-wide proceeds from privatization. East Asia was next with sales of \$28 billion or 25 percent, followed by Europe and Central Asia (which includes the formerly planned economies of Central and Eastern Europe and the former Soviet Union) with almost \$20 billion or 17 percent. The rest of the developing world combined was responsible for only about 12 percent of the value of sales.

However, since state ownership in developing countries represent on average about 10 percent of GDP in developing countries, there are still a lot of assets in state hands..

B. International investment and trade

In a recent speech² James Wolfensohn, President of the World Bank pointed out the dramatic changes in the flow of funding to developing countries over the past 10 years.

"(Some 10 years ago) development assistance (from governments and international institutions) was running at a net flow of roughly US\$ 40 billion a year, and private sector funding was close to \$20 billion. Today, 10 years later \$44 billion comes from official funding and \$256 billion from the private sector."

¹ Peter Young. "The Lessons of Privatization," and Mary M. Shirley, "Trends in Privatization," *Economic Reform Today*, 1998

² James D. Wolfensohn, Speech to the 7th International Trade Conference of the Economic Strategy Institute, May 6, 1998

Privatization has a particularly strong influence over decisions to invest. Studies of national experience has demonstrated that each dollar of privatization revenue generates an extra 38 cents in new investment -- with financial and infrastructure privatizations having the most positive effect on other foreign direct investment³. In fact, the national drive for foreign investment, and the national commitment to privatization are mutually supportive. A recent news report from Pakistan pointed out that Pakistan delayed privatization of national Habib Bank due to a lack of investors interest because of the "socio-economic conditions of the country and the East Asian region"⁴. These are the same conditions that limit the attractiveness of the national economy to foreign direct investment. One consultant with extensive experience in privatizations in the FSU region has suggested that

*"Privatizations of state-owned enterprises are successful when conducted in a stable, predictable - and possibly wealthy - economic and social environment"*⁵

The role of transnationals in the provision of FDI must be recognized. In 1998, it is expected that such TNCs will have undertaken US\$ 440 billion worth of investment, a rise of 10% over the previous year. Such investment plays an important role in trade, since it is estimated that TNCs now account for 7% of the global domestic product. Such transnationals have become the focus of privatization efforts; sales of SOEs in such sectors as telecommunications and utilities have been largely to TNCs.

Equally, the success or failure of privatization programs impacts on the success in the nation's trade objectives. For example, the collapse of the GOSPLAN, which provided for export markets for state-owned enterprises in the FSU, eliminated the demand for very SOE's about to be privatized, - and this at the time when they needed such demand to support the re-structuring efforts. The collapse of the state trading companies eliminated the marketing arm for the companies concerned, just as they were most needed to support re-structuring and renewal.

Dr. Karl Sauvart, of UNCTAD, in a recent article identified the success which governments have had by the development of "created assets" which are used as incentives to attract FDI⁶. Created assets are those which are man-made, and include such activities as a national commitment to the development of human skills, or the privatization of infrastructure, both designed to attract foreign investment.

³ Peter Young, "The Lessons of Privatization," and Mary M. Shirley, "Trends in Privatization," Economic Reform Today, 1998

⁴ Himalayan Online News Service, Karachi August 3/98

⁵ Privatization and Industrial Policy, Claude Potelle, December 1998

⁶ Global Finance – December 1998 – How to prime the FDI engine, Karl Sauvart, Chief International Investments, Transnationals and Technology Flows, UNCTAD

C. What role exists for the international aid community ?

There is little argument that privatization has proven successful in the promotion of economic development. No contemporary observer can doubt that it is desirable. But there have been sufficient examples of failure, and enough apparent roadblocks on the road to success in many countries, that it must be acknowledged that successful privatization is a complex project requiring supporting infrastructure and cultural understanding. Especially in those economies with an extensive history of central planning, successful privatization requires dramatic changes in the full range of supporting legal, institutional and cultural norms. If success is to be achieved, and if the national government requires support, the full range of capabilities and interests of the international community will be needed, and should be applied.

However, it is not readily apparent that one nation's experience in the application of a privatization programme can be shared with another. In an interview given recently by Dr. Roman Frydman of New York University, in response to the question of whether such experience can be shared, he is quoted as saying:

*"Every country must be approached as a distinct case. The important question to ask here is whether there are any latecomer countries comparable in size or government structure to the countries that have already privatized. Without comparability, there can be little transference of lessons."*⁷

A successful privatization programme relies as much if not more on the national political environment and the political will than on the technical design of any programme. Thus, each country with different political systems and circumstance presents country-specific issues that limit transferability of their programs to others with different situations. The privatization process is highly political in nature and must be thought through carefully by policymakers.

If this is true, to what purpose would we call for international cooperation in privatization and regulation? Simply because there are lessons which can be learned from every country for transfer to other countries; such issues as the role of public awareness and transparency in the achievement of successful privatization; or the impact which a specific skill base has had on achieving success. So, although there is no one single and appropriate formula for privatization that can be applied in all countries, all governments can benefit from the lessons learned by others. And thus there is a role for the international community in the promotion and sharing of these lessons, assisting latecomers to the process to avoid the pitfalls which endangered others.

Given the urgent need to restructure state-owned enterprises (SOEs) in a process appropriate to a country's political and economic conditions so as to allow market forces to operate, if there are lessons to be learned which can be transferred to other countries, we must encourage the process by which this can happen.

⁷ Economic Reform Today Interview, Dr. Roman Frydman, 1998

D. Some lessons to be learned

There are lessons to be learned. Dr. Madsen Pirie of the Adam Smith Institute⁸ says that recent international experience has provided us with ten such lessons, which can help steer decisionmakers in the right direction. We, who practice in the support of privatization, may not agree with all of these, but they are worth noting, in passing:

- 1. Policymakers should clearly understand that their goal in privatization is the transfer of state-owned enterprises to the private sector, and not to sell off state-owned enterprises (SOEs) to raise money to pay off foreign debt, for example. They may also wish to encourage competition, extend private ownership, modernize old industries, and replace timid bureaucrats with innovative entrepreneurs. Privatization can have all of these benefits but governments must not lose sight of that primary objective.**
- 2. Governments must learn to relinquish control after the sale of SOEs. If the new owners remain subject to detailed rules of central planners, the potential benefits of privatization, such as the attraction of new investment, the efficient allocation of resources, and the benefit of market competition may be lost.**
- 3. Price regulation of a former SOE, which retains a near-monopoly position, must be based upon the control of outputs, not inputs. The formula first used in the privatization of British Telecom (BT) is a good example. Future price increases were linked to the consumer price index, but BT decided how to deliver services. (A recent paper on regulation of The United Kingdom utilities provides much clarity on this issue⁹)**
- 4. While the price for which the enterprise is offered for sale is a critical consideration, it is not the only one. Governments can often command a higher asking price by selling a state monopoly intact to a single foreign buyer. The advantages are clear: more money is available short-term to repay foreign debt, fund infrastructure and social improvements, or simply to allow immediate tax cuts. There are also serious disadvantages: an intact monopoly misses the opportunity to introduce competition, and employees and society as a whole won't share in the benefits of broad-based ownership. The correct policy, therefore, is to treat price as one important factor among several, and attempt to maintain a correct balance in each case.**
- 5. Make a break from the past. Policymakers should not overvalue outdated or grossly inefficient enterprises, or think they can recoup "public investments." Years of public subsidies were typically spent and not invested, and have no relevance to the firm's current worth.**
- 6. Choose the most appropriate method of privatization. There is no simple formula that works in all cases. Because every enterprise is different, and every country has a unique culture and traditions, each privatization must be tailored to specific circumstances.**
- 7. The choice of buyer determines the best method of privatization. The sale can be structured to attract the available buyers, whether other corporations, or professional investors, the management and work force, and the public at large. There are good ways to sell to individual investors, whether or not the country**

⁸ Madsen Pirie (President, Adam Smith Institute), "Policymaking and Privatisation: Ten Lessons from Experience," Economic Reform Today, No. 1, 1998

⁹ Lowe, Peter, The reform of utility regulation in Britain: Some current issues in historical perspective Vol. 32, Journal of Economic Issues, 03-01-1998, Journal of Economic Issues – Association for Evolutionary Economics

has a developed stock market. Every privatization transaction should encourage wider share ownership whenever possible.

8. Always consider the investment needs of the enterprise itself. If a state company urgently needs new investment, then an investor with cash is obviously preferable to employees making payments over several years.
9. Do not restructure before privatizing. Although state companies tend to be outdated, inefficient and overstaffed, practices must be modernized, costs trimmed and the labor force reduced, it is better to let the new owners make these commercial decisions than to attempt to make the decisions for them. The United Kingdom National Audit Office determined that many privatization transactions yielded lower proceeds because of badly managed restructuring prior to the sale.
10. Identify groups affected by privatization, and when politically necessary, incorporate special measures to elicit their support. Workers will be concerned about job security and wages after privatization. They are more likely to support the process if they can buy shares at discount prices and/or are permitted to pay for shares from future earnings.

I am sure that many of us would add other important lessons based upon our experience and certain that some would argue with some of those listed above. The salient feature is that there are lessons and techniques that are useful for the latecomer to the privatization process.

E. Technical cooperation in capacity building and sustainable institutional development

This clearly leads to the need and the opportunity for technical cooperation and capacity building in national environments - which is after all the vocation and role of the international aid and development agencies. And thus there is good justification for the fact that almost every such agency has a range of activities that can support privatization programs in most aid-recipient countries. Each agency or institution may have a unique role in support of economic development, but each has found that to adequately fulfil that role, when a nation embarks on a privatization program, they are called to assist.

As one such example, UNCTAD has developed a programme that seeks:

- to provide assistance to Governments and their privatization agencies in formulating and implementing privatization policy and programs; to strengthen relevant national capacities;
- to promote a better understanding of privatization issues and experiences in particular sectors such as public utilities
- to promote contacts between Governments agencies and private sector entities.

Much of UNCTAD's work is accomplished through the gathering of Ad Hoc committees of national privatization practitioners, which committees produce instructive documentation

In the past, UNDP has produced a major publication¹⁰, which details the basics of privatization. More recently through its partnership in country programming with national governments, the UNDP has provided technical assistance in support of capacity building, enterprise restructuring and capital market

¹⁰ Guidelines on Privatization, published by UNDP, 1991

development. The United Nations, through the former Department of Development Support and Management Service (UN/DDSMS) has published several documents including a particularly useful report on privatization workshops held in Bangladesh and Kenya in 1992.¹¹

The multilateral development banks have been the most active in support for privatization, especially through the provision of financial credits to support privatization programs, and technical assistance funds to support them. This list is by no means exhaustive, but only demonstrative of the range of multilateral and national agencies active in support of national privatization efforts.

F. Inter-agency Cooperation

There is a clear need to establish some form of *cooperation among agencies* active in the support of national privatization programs. Although it may represent an old and distant call, in a world of limited aid resources, there is still an urgent need for inter-agency cooperation and counsel. In the past, UNDP has supported the establishment of *interregional networks* that linked the na

¹¹ Methods and Practices of Privatization, published by UN/DDSMS, 1992

tional privatization agencies, and supported,

in partnership with other UN, multilateral agencies or national aid agencies seminars and workshops to promote the sharing of ideas and resources. There may be much less need for such networks these days, given the extant privatization experience of many countries, and the available documentation now in print, but there is still need for some coordination in the provision of support from competing agencies.

There is also need for a *clearing house* of privatization issues, concepts, resources and activities. I note with satisfaction that the World Bank has established a second internet-based network (second to the successful IPANet related to international investment) on privatization, which attempts to fill such a requirement. I look forward to the recommendations of this group as to how such inter-agency cooperation and sharing of information and resources can be best achieved.

XIII. THE GHANA EXPERIENCE

A. Introduction

In the background information to this meeting it was stated that where the framework of privatization has been decided upon, the follow-up activities determine its mode of implementation. This goes to buttress the fact that the question on privatization in many countries is no longer whether it should take place, but rather how. Further, it was stated that the rationale of the meeting was to learn of new developments and issues from other countries; to examine and compare country experiences; to identify successes and failures; and to prepare a report on the conclusions for distribution.

This paper is offered on Ghana's experience in the process of privatization. The paper is based on documentation from the State Enterprises Commission (SEC) and the Divestiture Secretariat. The role, activities and functions of the Secretariat include:

- support of the work of the Divestiture Implementation Committee (DIC);
- work on individual transactions and appointment of consultants to undertake evaluations and assessments on selected SOEs; and
- publication of internal material, advertisements and negotiation with investors.

The secretariat draws on the expertise of multi-disciplinary consultants and experts in the preparation of reports, memoranda and minutes for the consideration of the DIC. Data for this is also derived from Consultants and other official reports as well as international documentation. I intend to structure my paper along the following lines in order to capture the most salient issues as they relate to Ghana's efforts on privatization:

- the need for divestiture in Ghana;
- the divestiture programme;
- the implementing agency (DIC);
- the enterprises to be divested;
- the mode of divestiture;
- results so far achieved;
- investment opportunities in divestiture;
- incentives for investors;
- receipts from divestiture;
- impact of divestiture on the Ghanaian economy;
- the way ahead; and
- the conclusion.

To begin with, I wish to state that in Ghana the words "privatization" and "divestiture" are virtually interchangeable and mean the same process, i.e. the transfer of a public enterprise to private hands, foreign or local. It is a process in which interested investors bid to purchase (wholly or partly) an enterprise, with the winner selected on the basis of, among other things, evaluation of management capacity, financial resources and business plans.

For a meaningful privatization process to take place, an enabling macro-economic policy environment should be created, including institutional and legal frameworks and financial sector reforms.

B. The need for divestiture in Ghana

After the achievement of political independence, the need arose for the Government of Ghana, and in fact for all sub-Saharan Africa, to initiate policies for sustainable industrial development. In Ghana in particular, in the absence of functioning capital markets, local private investments were negligible, and therefore the Government was compelled to establish and manage new enterprises. Therefore State-owned-enterprises (SOEs) became the economic development cornerstone of government policy. Indeed in the first 30 years preceding Ghana's independence, as many as 324 SOEs were set up in all the sectors of economic endeavour in Ghana. Out of the 324 SOEs, the State held 100 per cent interest in 181 enterprises, majority interests (51-99 per cent) in 54 others and between 30 per cent and 40 per cent in the rest. Apart from these the State had interests in several subsidiary companies which were formed through joint ventures with the banks and other institutions in which the State held between 10 per cent and 30 per cent of the shares.

The period of setting up the SOEs and ensuring State control over the management of the SOEs by Government became known in the economic history of Ghana as the era of State capitalism because the State held the commanding heights of the economy, controlled virtually all aspects of production and distribution of goods and services and became the leading employer.

However during the 30+ years of its existence the SOE sector did not perform as expected. Several factors contributed to this, the most important being lack of incentives, lack of technical and managerial expertise, excessive bureaucracy; over-staffing, and the absence of the commitment and entrepreneurial drive that private investors bring to business.

In addition to these factors, the SOEs suffered from inadequate investment and obsolete plant and machinery. As a result, the Government had to spend the scarce resources available to subsidize the SOEs, rehabilitate them and in several cases provide the administration back-up.

As a result of the several problems encountered, it dawned on the Government that it could not and should not act as an entrepreneur while at the same time play the role of a policy maker. In short, the

State had no business in doing business. Its basic role is to provide the enabling macro-economic environment for the private sector to do business and thereby emerge as the engine of growth. The above policy change meant that serious changes could not take place in the economy without appropriate changes in the management of the SOE/Government interface and the public/private sector relationship.

C. The divestiture programme

In 1993, the erstwhile PNDC Government, realizing the damage done to the economy by past successive governments, launched the Economy Recovery Programme (ERP) as a major macro-economic policy framework to stimulate and sustain the growth of the economy. Thereafter it was realized that further programmes should be put in place to consolidate the modest gains of the ERP. Therefore with the financial assistance of the World Bank, the State-Owned Enterprises Recovery Programme (SOERP) was established in 1988 to restructure the viable and strategic SOEs, divest some, and, to monitor the performance of the others by means of a performance monitoring and evaluation system (PMES) which included corporate planning, performance contracting and an annual cycle of performance monitoring and evaluation, by the State Enterprises Commission (SEC).

The objectives of the SOERP are to:

- improve the efficiency and the productivity of the SOEs and ensure that they operate in a fully commercial and competitive manner;
- reduce the reliance of SOEs on Government's scarce financial, managerial and administrative resources; and
- reduce the role of Government in activities that can be handled more efficiently by the private sector.

The divestiture programme is a policy option through which the Government expects to dispose of, in various ways, strategic and non-strategic enterprises, thereby reducing the size of the SOE sector and promoting consolidation of the private sector as an ever-increasing contributor to the socio-economic development of Ghana.

The programme is a modest attempt to unlock the economic potential of Ghana by permitting resources—people, money and technology—to be put to their best use and by increasing efficiency to achieve better living standards for all. It has an added goal of improving the performance of SOEs by mobilizing private sector management and capital. By this, the State will be able to make the business of Government more efficient, using the proceeds from the sale of SOEs to improve infrastructure, health services and education.

D. The implementing agency

It has already been explained that the SOERP is a holding strategy consisting of both measures to improve the performance of enterprises where they remain State-owned and the rationalization of the state-owned enterprise sector by means of the divestiture programme. For this purpose the Divestiture Implementation Committee (DIC) was set up by the Government in 1988 to implement and execute all Government policies pertaining to the divestiture programme.

Detailed information on the DIC is given in a statute, "The Divestiture of State Interest (Implementation) Law, (PNDC Law 326)", which assigns to DIC the statutory responsibility to divest all enterprises approved by the Government for divestment.

Among the specifically stated functions of the DIC under the stated law are:-

- to explain, monitor, coordinate and evaluate all divestitures;
- to arrange for the effective communication of Government policies and objectives for any divestiture;
- to develop criteria for the selection of enterprises to be divested and assume responsibility for preparing such enterprises for divestiture;
- to make appropriate consultations for successful processing of all divestiture programmes;
- to ensure consistency in procedures for divestiture, in particular with regard to valuation, invitation for bids, negotiation for bids, negotiation of sales and settlement of accounts.

The membership of the DIC is made up of ministers of State, the Trade Union Congress, institutional and private sector representatives. Representatives of the private sector are included in the DIC and this is in recognition of government's policy to make the sector the engine of growth. The Ministry of Employment and Social Welfare, together with the Secretary General of the Trades Union Congress, are very important members of the DIC and help take care of labour and employment issues. As already explained, there exists a Divestiture Secretariat headed by an executive secretary who is in charge of the day-to-day administration of the DIC. The DIC meets regularly to consider, among other things, specific transactions negotiated by the Secretariat, and submit, as applicable, recommendations to the Office of the President for approval.

The DIC has several specialized sub-committees, such as committees on the mining, cocoa and coffee industries. It receives financial, legal and technical support and advice from the World Bank and from the British Fund for International Development (BFID).

E. Enterprises to be divested

The list of enterprises to be divested is prepared and given to the DIC by the Government. Most of the SOEs currently listed for divestiture are in the agriculture, manufacturing, wood processing and tourism sectors. The Government selects the enterprises with the principal aim of minimizing economic disruption, maximizing their favourable impact on the economy, and increasing future tax revenues.

F. Mode of divestiture

Enterprises could be divested as going concerns i.e. as whole entities, or in fragmented parts depending on the size. So far, the main mode of divestment has been the sale of assets of the enterprises to private investors. Sales of shares where the private investor becomes the majority shareholder and manages the divested company, as well as joint venture arrangements between the Government and the private investor and the leasing of the company's assets, are also available options. Enterprises with very low foreign or local investor interest, or of little interest to the economy, are liquidated.

G. Results of divestiture so far

As of October 1998, about 212 enterprises had been approved by the President's office for divestiture according to the following modes of divestment:

Mode	1989- 1991	1992	1993	1994	1995	1996	1997	1998	Total
Sale of assets	16	4	3	30	19	18	15	7	112
Sale of shares	11	5	2	2	6	1	2	2	31
Joint venture	6	3	1	4	-	4	1	2	21
Lease	3	1	-	1	-	-	1	0	6
Liquidation	24	2	5	5	6	-	-	-	42
Total	60	15	11	42	31	23	18	11	212

H.Divestiture and investment opportunities

The seriousness and the commitment on the part of the Government and the people of Ghana with respect to the divestiture programme cannot be doubted. The acceleration of the divestiture programme by which some divestitures have been out-sourced to private consultants is a clear manifestation of the Government's commitment to the programme. Consequently international investors from countries all over the world are warmly invited to take advantage of this opportunity and participate in the divestiture programme. Ghana has abundant natural and industrial resources with more than 13 million hectares of arable land for crop production as well as over 600,000 metric tons of fisheries products. The current list of enterprises to be divested contains manufacturing, agriculture, mining, timber and tourism companies. Interested investors have the opportunity to personally inspect the assets of the enterprises as well as their operations and records. DIC arranges such site visits and any meetings that an investor may require. It is noteworthy that under the divestiture programme all SOEs under the performance contract system supervised by SEC are slated for divestiture.

I.Incentives for investors

Several incentives are available to interested investors who wish to participate in the divestiture programme. On the divestment of an enterprise it becomes the responsibility of the Government to terminate the employment contracts of all employees and bear the cost thereof. Consequently the new owner is given the opportunity to select his own new staff. Additionally, the liabilities of the enterprise are fully assumed by the Government except for a few special cases where the mode of divestment is the sale of shares.

The following advantages and incentives also accrue to prospective investors in the divestiture programme: customs import duty exemptions, tax holidays, generous capital allowances, location incentives, income tax incentives, investment guarantees, free transfer of capital, dividends and net profits, quota-free access to The United States and European markets, investment dispute settlement through the World Trade Organization and International Center for Settlement of Investment Disputes, duty free export trade zones, preferential access to 15 other markets of the ECOWAS, and demonstrated commitment to market liberalization

J.Divestiture receipts and payments

The DIC provides the following information on divestiture receipts and payments as at November 1998:

- an amount of \$601.7 million has been earned from the divestiture of 212 State-owned enterprises.
- out of this amount, about \$400 million was realized from the divestiture of the Ashanti Goldfields, one of the most prestigious gold mining companies of Ghana.
- part of the receipts from the programme was used to settle employees' accumulated salary arrears, and debts owed to creditors of the enterprises.
- as of August 1998, such liabilities totalled about c214 billion (approximately \$53 million) and the DIC was able to settle c77 billion (\$19.25 million) leaving a balance of about c137 billion (\$34.25 million) to settle.
- transfers to the government from divestiture between 1991 and 1998 were about c32.2 billion (\$8.05 million).

- **the need to promote more indigenous participation is recognized. However local investors face the difficulty in assembling and pooling resources for the purchase and rehabilitation of enterprises offered for sale. However, out of the 212 enterprises divested, 103 were successfully completed with local investors.**
- **in addition, the DIC was able to negotiate for 20 joint ventures between local and 23 foreign investors. A summary published by DIC on the cost (value) of the SOE sold, the consideration received from the possible investor, the expenses incurred on divestiture (including pay-offs for dismissed workers and end-of-service benefits) and outstanding payments from investors shows that between 1989 and 31st August 1998, 36.1 per cent of total debts of the proceeds from divestiture were outstanding, investors in about 52 divested companies (30.1 per cent) out of the 212 have not fully paid their required consideration fee as expected, and a debt obligation of 57.8 per cent of these investors has been outstanding since 1996.**
- **until 1996, the SEC, the oversight agency in charge of the management of State/SOE interface, was responsible for preparing the SOEs and recommending those for divestiture to the Government. However, after 1996 a policy of accelerated divestiture was adopted and a process of outsourcing, described as "privatizing the privatization programme" was set in motion and the SEC ceased to be consulted. It was apparently discovered that SEC's role in this regard contravened section 3 of the DIC Law.**
- **the Government has so far spent almost \$2 million on consultants since the outsourcing programme started in June 1996. But the benefits of outsourcing divestiture to consultants of merchant banks etc. have been negligible. Since the inception of the outsourcing programme, 21 companies have signed contracts for outsourcing. Yet there were so many delays that the pace of the so-called accelerated divestiture is now slower as even before and the World Bank lost interest.**
- **meanwhile only one SOE has been divested during the process of outsourcing and, as a result of this poor performance, the Ministry of Finance has taken steps to evaluate proposals from independent consultants on the whole system of outsourcing with recommendation for improving the programme in order to derive greater benefits and reduce the delays in divestiture.**

K. Assessment of the impact of divestiture on the national economy

In an attempt to assess the impact of divestiture, a study commissioned by the Ministry of Finance to a consultancy group of the Kwame Nkrumah University of Science and Technology (KNUST) focused among other things on the following vital issues:

- **The performance of the divested SOEs;**
- **New investment, organization and decision making;**
- **Employment and labour;**
- **Government finances;**
- **Non-financial responsibilities of Government;**
- **Goods and services availability and their prices;**
- **Structure of ownership of the means of production;**

- The financial system of Ghana;
- Technology transfer; and
- Environmental considerations.

The final report is yet to be submitted.

(a) Macro-economic impact

These issues relate to a major factor such as how the divested SOEs have performed?

Let me now recount a few of the successes and/or failures of privatization in Ghana by addressing a few performance indicators viz: how have sales increased or decreased? how are profits increasing or decreasing? has productivity gone up or slumped? and are the divested SOEs breaking through in the areas of working capital, capacity utilization, markets, service and most importantly, management practices.

Time does not allow me to answer these questions in detail. It suffices to observe generally that:

- Sales have gone up considerably;
- There has been an aggregate change in labour productivity;
- Through new investments, the level of working capital has increased;
- Capacity expansion and utilization have also doubled since the predivestiture period and have both contributed to new investments and improved quality of service in the service industries, especially in the hospitality industry;
- Sales promotion has gone up;
- Most of divested companies, at least 68 per cent, have turned their losses into profits;
- There has been a general growth in the divested companies, especially those in the mining sector which have grown about 125 per cent. The increase in the profit/sales ratio has been about 950 per cent, an indication of cost reduction. Their contributions to government revenue in the form of taxes and dividends have been very encouraging; and
- There has been a positive impact in the mining, manufacturing, services and agriculture sectors with increases in sales of 6.5, 275, 103 and 3.2 per cent respectively.

(a) Social impacts

It should be said that on the social level there has been an observable decrease in the labour force in some of the divested industries, which has allowed the new owners to "start with a clean slate".

The investors have been allowed to employ staff according to their needs. As a result, job security, and the protection and payment of adequate employee-related benefits seem to have been made available and labour unrest on the surface has been reduced to the minimum. But in reality, trade union militancy seems to be increasing, due partly to the unfortunate arrogance and disrespect of some of the new investors. This is breeding

dangerous militant labour union activity in some of the divested SOEs, which in the long run may affect stability and long-term foreign investment in Ghana.

One of the most important aspects is the process of retrenchment or redundancy in the divested SOEs. Some of the workers who were declared redundant and promised training in other skills never received any training and hence constitute a latent threat to civil society.

In the Ghanaian SOE set-up, a tradition has been an established which obliges the SOEs to carry out certain social activities in the community in which they are located. In fact in all the performance contracts of the SOEs, this non-commercial activity is emphasized. However, with the divestiture of a majority of the SOEs there appears to be a huge reduction in these direct community development activities.

There are other negative impacts of divestiture which could not be stated here. The whole issue of impact assessment of divestiture in Ghana demands another paper. As indicated above, the picture will be clearer when the on-going impact assessment report is finally presented to the Government for its final policy paper.

L.The way forward

The Government's intention to keep the programme alive has been formulated under a Reform Operation Economic Support Programme, by which the privatization of certain enterprises is to be outsourced. These SOEs are in the energy, transport and banking sectors. The Government will also grant concessions in the railway sub-sector while the Ports and Harbours Authority would have its operational units leased out. The Authority remains the landlord. These arrangements are intended to push forward the divestiture programme.

It has been observed that the stakeholders are becoming impatient with the sluggish way the DIC is directing the affairs of the programme and the Government has been called upon to act with dispatch. A slippage of the programme will be very costly to the Ghanaian economy.

M.Recommendations

- **It is important to prepare the SOEs for their divestiture as going concerns. Documentation on them should be prepared at the pre-divestiture stage in order to handle the post-divestiture issues more easily.**
- **Further investments should be encouraged to ensure higher employment levels. Also, steps should be taken to guarantee increased regular, financial inflows in the form of taxes and dividends into government chest.**
- **Now that the Government's involvement in the direct management of the divested companies has ceased, it should concentrate on the formulation of macro-economic policies that would secure employment and enterprise development.**
- **The necessity of new investments to ensure the viability of the divested companies cannot be over-emphasized. Therefore, to ensure the continuous participation of new strategic investors in the divestiture process, the Government should grant taxes and other reliefs if new investments are made.**
- **Greater capacity utilization should be advocated by the Government in order to promote job creation and productivity of labour.**

- **A very important component for the success of divestiture is technology transfer. Therefore, it should be a basic consideration in the divestiture process. Human resources development programmes and other research and development should be enforced.**
- **Environmental protection should be a condition of purchase of SOEs. Government should make sure that budgets for environmental protection are drawn up by the divested SOEs to ensure more serious, effective and efficient environmental management and protection.**

A. Conclusion

Several studies of the divestiture programme in Ghana conclude that, as of now, there is every indication that the programme has been widely successful even though it is also evident that privatization does not solve every social and economic problem and cannot be regarded as a panacea for all economic ills. The divested companies in Ghana are making a steady headway and are contributing immensely to government revenue and improvement in the economy. And even though some of the companies are not performing exactly as expected, there is every reason to believe that divestiture profits and receipts will increase in the near future when the initial investment hiccups are overcome. One has to keep in mind that the programme started barely ten years ago in Ghana.

It is understandable that the success of the programme will depend mostly on the Government's ability to formulate effective policies, regulations and sustainable

measures to address the bottlenecks in the macro-

economic environment such as high utility tariffs; stiff competition from cheap imports; high interest rates; lack of credit finance; low purchasing power of the people; low productivity, limited capital market, labour unrests, etc.

However, with cautious optimism within the framework of the present democratic dispensation which has secured political stability and a steady growth of the economy, it is envisaged and hoped that the privatization process will be pursued to its logical conclusion with all its positive impacts.

XV. PRIVATIZATION IN MALAYSIA

A. Introduction

Privatization was introduced in Malaysia in 1983 at a time when public debt was increasing, Government's involvement in economic activities had become too extensive, Government-owned companies were losing money and the number of public sector employees was large. The policy became a major impetus towards promoting the private sector as the engine of growth in the development process. It was based on the premise that the transfer to the private sector of activities and functions which had traditionally rested with the Government would bring about positive changes in the organization, management and performance of public enterprises. In Malaysia, privatization covers a broad scope including state-owned enterprises and companies as well as new projects such as the construction projects in the infrastructure, utilities and energy sectors. In terms of modes of privatization, apart from divestment of state-owned enterprises, Malaysia has adopted other modes including build-operate-transfer (BOT), build-operate-own and build-transfer, which are utilized for new projects. Privatization now forms one of the important instruments of the Government economic programme towards achieving the national vision of a fully developed nation by the year 2020.

Since its inception, a total of 425 projects have been privatized. Of the total, 333 represent existing projects involving the takeover of Government's functions by the private sector while the remainder represent new projects involving the construction of infrastructure and utility projects such as land development, roads, light rail transit systems, independent power producers and water supply projects.

The privatization programme in Malaysia is broad-based, covering various facets of the economy, such as telecommunications, energy, airline, airports, shipping, seaports, roads and highways, hospitals, vocational training institutes, broadcasting, water supply, hotels and resorts, abattoirs, postal, sewerage, ferry services, railways, Government owned companies such as sugar and cement factories, printing, quarries and steel mills. Some major privatized projects are the North-South Highway, Malaysia Airlines, Perusahaan Otomobil Nasional (PROTON) and seaports of Johor, Klang, Bintulu and Pulau Pinang, the Kuala Lumpur Light Rail Transit (LRT), airports, the national electricity company Tenaga Nasional Berhad, the postal and telecommunications services.

Privatization has succeeded in reducing the financial burden of the Government. To date, the sale of Government-owned assets and shares has generated proceeds of more than RM21.5 billion. In terms of annual operating expenditure, the Government has been able to save in the region of RM7 billion from privatized projects. As for capital expenditure, the saving is estimated at RM130 billion, including costs of investment plans to expand capacity, upgrade existing networks, improve and modernize services. The main financial relief comes from the savings on BOT projects as these represent the amount the Government would have to provide as capital expenditure if the projects had not been privatized. These savings enabled the Government to rechannel its funds to higher priority projects aimed at poverty eradication and the social sector. A total of 98,000 employees of public sector have been transferred to the private sector through the privatization exercise. This does not include personnel of Government-owned companies that are already functioning in a commercial environment.

There are indications that privatization has led to increased efficiency of privatized entities. This could be seen from the significant improvement in the performance of the privatized entities. In order to increase efficiency, the Government has introduced competition in implementing the privatization programme, especially in natural monopolies such as energy and telecommunications. In the telecommunications sector,

the Government has licensed other companies, apart from Telekom Malaysia Berhad, to provide telecommunications services, while for the energy sector, the Government has licensed 9 companies, apart from TNB, to generate electricity. The privatization of highways has resulted in a much faster rate of highway construction in the country, thereby helping to reduce infrastructure bottlenecks. Apart from stimulating the growth of the economy and reducing the financial and administrative burden of the Government, privatization has accelerated the construction of much needed infrastructure for development as the Government by itself may not be in a position to provide the financial allocation due to the limitation of resources.

Privatization has also played an important role in accelerating economic growth in at least three ways as privatized entities are profit motivated and are more flexible to pursue corporate expansion goals. Firstly, the efficiency gain as a result of privatization has led to growth as more output is produced using less resources. Secondly, resources that are released as a result of efficiency gains are being utilized for further corporate expansion. Thirdly, growth has been generated in a more direct manner through various BOT/BO projects and land development projects that encouraged private sector entrepreneurs to invest in sectors previously the domain of the public sector. This has led to an enhanced rate of infrastructure project implementation at a time when the public sector is cutting back its development expenditure.

B. Conditions for privatization

As the term implies, privatization refers to the transfer of activities and functions that are traditionally undertaken by the Government to the private sector. Therefore, privatization involves two distinct parties dealing in business with each other, namely the Government and the private sector. To promote the growth of privatization, there must be a conducive environment both in the public and private sectors which is healthy for its development. Apart from that it is important to create the necessary conditions for privatization to take place. The most vital condition is the presence of a well-developed private sector. A country will not be able to emulate the successful privatization experience of others if it does not have a well-established private sector supported by a conducive investment climate which will attract investment in privatized companies. In addition, among the conditions which are required for privatization are the following:-

- public sector recognition that some of its activities and functions, particularly those associated with commercial development, would be better undertaken by the private sector in order to improve their efficiency and productivity;
- public sector confidence in the ability of the private sector to participate effectively in privatization;
- private sector maturity and readiness to take investment risk especially for those activities which involve high risk, particularly those which have high social obligation;
- a well-developed financial market including commercial banks, institutional investors and a capital market which is ready to support large-scale investment in privatization; and
- abundant local expertise to support privatization.

These are some of the conditions which will help to promote the development and expansion of privatization in any country without which there will be no place for privatization. In this regard, Malaysia has been fortunate as these conditions have been well entrenched and have been developed over the years since independence.

A. Selection of privatization mode in Malaysia

The selection of mode of privatization contributes significantly to its success. We in Malaysia have utilized various modes of privatization in the implementation of the privatization programme. The mode selected will depend on the nature and type of project to be privatized. For privatization involving the selling of existing entities of the Government, the most commonly used methods include sale and lease of assets, sale of equity, management contract and management-buy-out, while for new projects the methods used are build-operate-transfer, build-operate-own, build-transfer and asset swap. In selecting the appropriate method, the one which results in the maximum degree of private sector involvement and a reasonable return to the Government will be chosen. Based on this principle, in some cases a combination of methods has been utilized. The selection of methods is illustrated in the following examples:

- the sale method can be used either for the privatization of Government equities or assets. *Sale of equity* applies normally to Government companies and results in the transfer of all the three organization-related components i.e. management responsibility, assets (with or without liabilities) and personnel. A sale of equity can either be partial, i.e. a transfer of less than 100 per cent, or a complete sale representing a transfer of 100 per cent of the Government equity. Among the companies privatized through this method include the Perusahaan Otomobil Nasional (PROTON), Malaysia Airlines, Heavy Industries Corporation (HICOM) and the Malaysian International Shipping Corporation. *Sale of assets* on the other hand, may or may not involve the transfer of all the three components and can apply to the assets of any Government organisation including company or any other types of entity. This method has been used for the privatization of projects such as quarries in Selangor and Perak, and Public Works Training Institute (IKRAM);
- *lease of assets* is applicable in the privatization of fixed assets particularly if the assets are large and strategic in nature such as seaports and airports. This method involves the transfer of rights to use assets for a specified period in return for specific payments;
- a *management contract* is used in the privatization of the management of a Government entity. This method involves contracting-in private sector expertise to manage a Government entity for a fee. It entails the transfer of management responsibility and may or may not involve the transfer of personnel but will not involve the transfer of assets. Examples include the privatization of the management of Kedah and Selangor Water Treatment Plants;
- *build-operate-transfer* (BOT), *build-own-operate* (BOO) and *build-operate* (BO) are used for privatization of new projects whose development was traditionally vested in the public sector including infrastructure, utilities and energy projects, such as roads, light rail transit systems, power, water supply, sewerage and solid waste projects. BOT involves the private sector constructing a facility using its own funds, operating it for a period and transferring it to the Government at the end of the period. During the period, the private sector is allowed to collect revenue from the users of the facility. Among projects privatized by way of BOT are the North South Highway, National Sewerage Project, Light Rail Transit Systems and

Express Rail Links. The BOO method is similar to BOT except that the former does not involve the transfer of the facility to the Government. Examples of projects privatized through BOO include independent power producers;

- other modes of privatization used in Malaysia include build-transfer (BT), land development, management-buy-out, reverse takeover, asset swap and joint venture.

A. Privatization policy issues

Privatization and social obligations

An important aspect to be addressed in privatization is the need for the privatized entities to undertake social obligations after privatization. This is particularly so as the privatization of projects, especially in the infrastructure and utilities sectors, has a direct impact on the public who are consumers of the services provided after privatization. In the case of Malaysia, the types of social obligation vary according to the project which include the following:

- the promotion of participation of indigenous people in the corporate sector;
- reasonable and affordable tariffs, charges and tolls in the case of infrastructure and utilities privatization;
- the maintenance of uneconomic lines and routes for the privatization of railways and airlines;
- manpower training and development; and
- technology transfer.

The need for the privatized entities to undertake social obligations has to be taken into account during the privatization process. In line with this, the prospective concessionaire will have to be adequately informed on the nature and types of social obligation to be undertaken and the company will have to consider the impact of such obligations on the return to the company after privatization. Such obligations will be reflected clearly in the form of specific clauses in the privatization agreement to be signed between the Government and the private sector party making it obligatory for the company to meet such obligations throughout the concession period. The various social obligations are reflected in the concession agreement.

With regard to the promotion of participation of indigenous people (bumiputra) in the corporate sector, a number of clauses have been provided in the privatization agreement requiring the private sector party to observe certain conditions (see below under Privatization and Distribution).

For infrastructure and utilities privatization, to ensure the viability of the privatization and reduce the impact of tariffs, charges and tolls, the company is provided with some assistance by the Government in the form of soft loans and advances for land acquisitions. With such assistance, the company is able to charge tariff and tolls at rates which are reasonable and affordable to the public.

Provision is also made in the privatization agreement for the company to undertake the training of Malaysians. Similar provision is provided in respect of technology transfer, requiring companies to ensure that their foreign experts undertake a programme of technology transfer.

Resistance and employees' interests

In order to ensure the success of the privatization programme, efforts should be made to gain the support of the management and employees of the affected entities. The support of the Government employees and unions is very vital to ensure the success of the programme. In our experience, those involved in privatization, particularly the Government employees, will invariably resist the notion of being transferred to the private sector as they are concerned about their security of tenure after privatization. The pure profit motivation of the private sector presents a threat to them. There is always a fear that such motivation may encourage the private sector to undertake cost-cutting measures, the worst form being retrenchment of the workforce. As most of them are union members, their concerns with regard to their welfare after privatization have to be given careful consideration in order not to invite opposition from the unions. In Malaysia, the Government introduced several policy decisions to protect the interests of employees after privatization which include:

- as a matter of policy, the companies taking over the employees should offer terms and conditions of service which are no less favourable than those they received from the Government. In this respect, the employees are offered a conversion rate of 17.5 per cent over their existing salaries;
- no personnel can be retrenched within the first five years of privatization except on disciplinary grounds; and
- in cases of privatization which involve public listing, the employees are offered a 5 per cent share of equity. Employee participation in the ownership of their enterprise is undertaken through the establishment of an employee share ownership scheme (ESOP).

Those personnel who opt not to join the privatized entity are retired and given retirement benefits immediately on retirement, while those joining the entity will be offered two schemes of service, one replicating the Government scheme while the other is commercially oriented. Any staff redundancy will be overcome through normal attrition, redeployment and expansion activities.

The generous initial terms given to affected employees in privatized entities is to ensure the success of the projects as well as to provide added encouragement and attraction to the employees who joined the private sector. Our experience demonstrated that privatization did not result in lay-offs, and has in fact resulted in wage increases. This has helped considerably in changing the employees' outlook on privatization, and unions have now become more supportive towards privatization.

With these policy instruments and other forms of benefit provided, there has been a general acceptance of privatization by the Government employees which has facilitated the privatization process. With little grievances raised by the employees, the unions therefore have no strong ground to oppose the implementation of the programme. In view of our experience, it is important to examine the extent of government employees' concerns over privatization and appropriate steps should be taken to ensure their interests are adequately safeguarded after privatization. It is only when the affected employees feel that their interests are not threatened that their support of privatization can be assured.

Regulatory framework

Although privatization entails deregulation and lifting of barriers in order to allow market forces to dictate economic activities and thereby improve efficiency and productivity, an appropriate regulatory framework is necessary, particularly in respect of natural monopolies. This is to ensure that consumers' interests are protected, especially in terms of price, quality and availability of services. The regulatory framework is responsible for protecting consumers' interests and public safety from monopoly power, promotion of social objectives and the creation of healthy competition in related industries. The role of the regulatory authority therefore is to ensure that there should be a balance between the objectives of protecting the consumers' interest and healthy development of the industry.

Generally, any review of tariffs and charges would require approval by the Government. As a general principle, tariffs are not allowed to be indexed to the consumer price index and are not subject to arbitration. For the purpose of regulation, various regulatory authorities were established to regulate the respective industries, especially on quality of service, adherence to standards, protecting consumer interests in terms of pricing and availability of services, and ensuring a healthy development of the privatized industry. Various regulatory authorities were established covering areas such as electricity and gas supply, ports, airports, highways, post, telecommunications, railway and sewerage. The tariffs are decided by the Government and any increases has to be approved by the Government.

To reduce the anxiety of consumers on the likelihood of increased tariffs, lowering of standards or quality of goods and continued supply of services, particularly in the case of the privatization of monopolies, the Government has stepped up efforts to educate the public on the benefits of privatization. As a result, there seems to be an increased awareness among consumers that they are now paying the actual costs of services which were previously subsidized by the Government and that they have to pay for the actual cost and quality of services provided. Any increase in price has been offset by improved quality and more effective services and this has helped to make consumers realize the benefits of privatization.

Legal issues

Implementation of the privatization programme will have legal implications on matters such as land, personnel and taxation policies which inhibit the implementation process. This applies if the existing laws do not provide avenues for privatization. In this light, the Government has to be pragmatic by amending the relevant laws and regulations as well as introducing new ones to facilitate the implementation of the programme. In Malaysia, the existing laws have posed unintended obstacles to privatization and efforts were made to amend the necessary laws. Legal constraints in respect of personnel have been surmounted by amendments made to the 1980 Pensions Act which has instituted pension rights for public sector employees who have opted into the private sector.

For some entities, provisions in their laws of incorporation prevented privatization. Such constraints were resolved with the introduction of various successor company acts such as in the cases of the Malayan Railway, the Telecommunications Department and the National Electricity Board. In order to strengthen the regulatory framework to ensure that the standard and quality set by the Government are adhered to by the privatized entities, a number of acts have been amended such as the Telecommunications Act, Electricity Supply Act and the Malayan Railway Act.

In cases where privatization involved Federal, State and local authorities, implementation was almost impossible. However to expedite the implementation of such projects, the projects were transferred to the

Federal Government, as in the case of the National Sewerage Project. This involved the passage of a new Sewerage Act and amendments to six other acts. The Government is pragmatic and responsive in dealing with the privatization of entities and will continue to amend existing laws in order to facilitate and expedite privatization.

Privatization and distribution

Privatization can also play a vital role in the achievement of the stipulated policy objectives of the Government, particularly with respect to the policy aimed at achieving equitable wealth distribution in a country. In the case of Malaysia, the objective of wealth distribution is to increase the bumiputra participation in the corporate sector and privatization forms an integral part of the Government's strategy in realizing this objective. Therefore, the programme has been used as a vehicle to correct the imbalance in the corporate sector by providing wider opportunities for bumiputra to participate in the privatization of Government companies. Towards this end, as a matter of policy, provision has been made for all privatized projects to have at least 30 per cent bumiputra participation. Other provisions were provided in the concession agreement to enhance and sustain bumiputra interests after privatization. These include the following:

- **the guidelines requiring minimum bumiputra participation of 30 per cent in the privatization exercise has to be adopted in order to provide opportunities for bumiputra to participate in the programme. Similarly, the various procedures pertaining to bumiputra participation in the listing will be continued to ensure bumiputra participation in the listing of future privatized entities;**
- **a provision is to be made in the concession agreement requiring the changing of ownership in the privatized entities to be in line with the National Development Policy and no change will be allowed in the initial stages of privatization. This is to ensure that the companies will always maintain the structure of their ownership in accordance with the national policies;**
- **the Government will encourage the vendor programme and the umbrella concept especially for privatization of major projects, so as to enable the small and medium-scale industries (SMIs) to participate and invest in privatization projects. The vendor programme has resulted in wider linkages between the SMIs and multinational companies that have provided greater opportunities for more SMIs to act as vendors of manufactured goods. The umbrella concept has resulted in greater integration of business activities by supplying and marketing products through a conglomerate under a large company. The introduction of these concepts has provided wide business opportunities and increased market share of these companies, and has encouraged and created new investors in privatized projects. To date, a number of privatized projects have implemented the vendor programme, such as Telekom Malaysia, which has introduced the vendor programme in its production of equipment and supplies for local networking. Currently, it has appointed six bumiputra companies under the vendor programme, while four others are being evaluated. PROTON has also introduced the vendor programme and has appointed 18 companies to produce component parts for its Proton Saga. At the same time, Proton has embarked on training programmes for 18 companies to be sub-contractors for their privatized project.**
- **another means of protecting the interests of the employees and management is through the promotion of the management buy-out (MBO) method of privatization. In fact, more privatization by MBOs is encouraged in order to ensure that the ownership of the companies will continue to be held by those involved in operating the company.**

- the introduction of the employees share ownership scheme (ESOS) also helps put the ownership of the companies into the hands of employees. The plan involves the establishment of a trust to hold shares for the employees. Financing for the purchase of shares by employees will be arranged by the trust. Employees will only be able to sell their shares when they leave the company or upon retirement.

Foreign direct investment and participation

Although privatization provides an additional avenue for investment for local investors, foreign investors should be encouraged to participate in privatization especially in those areas where local expertise and technology are not readily available. In addition, foreign investment in privatization also provides an alternative source of financing which complements other forms of financing available locally. Therefore, a conducive investment climate should be created to promote foreign investment in privatization. In order to ensure that maximum benefit could be derived from foreign participation, Malaysia has adopted a policy to limit foreign participation to a maximum of 25 per cent of equity. Management expertise and debt financing can be considered by the Government in the following cases:

- where foreign expertise is needed to upgrade efficiency and such expertise is not available locally;
- where foreign participation is required to promote exports;
- where the supply of local capital is insufficient to absorb the shares offered; and
- where the nature of business requires global linkages and international exposure.

Examples of projects which have foreign participation for the purpose of upgrading skills and technology transfer are the National Sewerage and Light Rail Transit projects. For projects of strategic and national importance, foreign ownership is considered selectively in order not to compromise the national interest.

A.Pre-requisites for success

National consensus on privatization

To ensure the success of privatization, it is essential to establish a national consensus on the importance of the programme as an instrument for economic growth. The national consensus refers to the general acceptability of the programme by the country, namely the Government including the policy formulators and the administrators, unions, opposition parties and NGOs. In order to achieve national consensus on the programme, a number of policy instruments have to be in place. This includes continuous campaigns on the positive aspects of privatization undertaken by the Government through the various mass media including newspapers, radio and television. National dialogues and seminars on privatization are organized from time to time with a view not only to expose the public to the various aspects of privatization but, more importantly, to build their confidence in the importance of the programme as an effective instrument of economic growth.

The Government's effort to educate the public on the benefit of privatization resulted in an increased awareness on the part of consumers. There has been concern over tariff increases and the lowering of quality and standards of service and the assurance of supply, apart from questions on why charges have increased after privatization. Consumers have been informed that they are now paying the actual price of services which previously were subsidized by the Government, through hidden costs, such as operating costs. They have now to pay for the actual cost and quality of services provided. Any increases in price have been offset by improved quality and more effective service and this has helped to make consumers realize the benefits of privatization. However, in natural monopolies, the Government has clearly stipulated in the privatization

agreements that any increase in tariffs must obtain prior approval of the Government. This has further safeguarded consumer interests and ensured that privatized entities conform to the tariff rates stipulated by the Government.

The Malaysia Incorporated concept

Malaysian privatization is based on the Malaysian Incorporated concept, that is, to foster close cooperation between the private and public sectors to achieve economic development. The Malaysian privatization programme is based on allowing the private sector to lead economic growth and the public sector providing a conducive environment, incentives, and other support necessary to enable privatization to be successful. The private sector is encouraged to submit proposals for privatization and approval is based on merit and the benefits that both parties will reap from the project. In addition, the Government has always emphasized viability of privatization projects. At the same time, companies are also required to implement the vendor and umbrella programme so as to provide opportunities to other companies to participate in privatized projects.

Determination and commitment

The privatization programme symbolizes the Malaysian Government's determination and seriousness to instill a commercial culture in the public sector, to the extent that the Government is prepared to transfer its business to the private sector. The commitment to this programme is strongly evidenced by the acceptance of privatization by both the Government and people as an instrument of economic management. The Government is committed to ensure the success of the programme and this determination has influenced the administration and workforce, especially in the privatized entities, to strive towards this objective.

Planned implementation

The success of any development effort including privatization is highly dependent on the ability of the country to plan and coordinate implementation in a conscious and systematic manner. Proper planning is an important element to ensure successful implementation of the privatization programme. In this regard, we engaged a team of qualified foreign and local consultants to undertake a study of the Privatization Master Plan for Malaysia. The Plan details various aspects of privatization including the administrative machinery for privatization, which is based on centralized planning at the Economic Planning Unit, Prime Ministers Department and decentralized implementation by the ministries and State Governments, selection of modes of privatization, approach to privatization, valuation methods, establishment of privatization priorities and steps to sustain the implementation of the programme.

In addition, a two-year rolling Privatization Action Plan has been put in place to assist the privatization process. The two-year rolling plan contains a list of projects identified for privatization which is reviewed annually to assess the progress of its implementation and identify implementation bottlenecks and formulate measures to overcome the problems in order to accelerate implementation. In addition, the review enables the Government to incorporate new projects to be privatized over the next two years.

With the adoption of the Privatization Master Plan and the two-year rolling plan, the implementation of the privatization programme in Malaysia has been significantly accelerated to the benefit of the country. It is therefore vital for privatization to be carefully planned in order to ensure its smooth implementation. Thus, adequate time should be provided for the Government to formulate proper strategies for the implementation of the program.

Coordination and implementation authority

Malaysia's privatization process is transparent and clearly defined. The administrative machinery established to implement the programme is based on the principle of centralized planning and decentralized implementation. The setting up of the Privatization Section in the Economic Planning Unit (EPU) creates a separate entity that handles privatization projects objectively based on careful considerations and sets guidelines and procedures as provided in the Privatization Masterplan, while the Committee on Privatization at the EPU ensures that these procedures are adhered to.

There is a clear division of functions between central agencies and the ministries. EPU is the central planning authority directly under the Prime Minister and is responsible for all matters relating to privatization. The Government has made a clear administrative decision that all proposals initiated by the private sector have to be submitted directly to EPU for further consideration. The ministries and departments are therefore required to send all proposals received from the private sector to EPU. EPU coordinates the various aspects of privatization such as legal, financial and technical. EPU also ensures that the respective ministries and agencies undertake certain measures to facilitate the privatization exercise.

B. Policy issues

The privatization policies that have been stipulated in the Privatization Master Plan are still being enforced. However, the current economic and financial situation has affected the implementation of some privatized projects, particularly those which require high capital investments. The privatization programme will be continued with some policy adjustments and based on the following criteria:

- projects that have multiplier effects on the economy;
- projects will be implemented in phases;
- projects which are export-oriented;
- projects with low import content; and
- projects that promote higher quality of life.

A. Uniqueness of Malaysian privatization

Compared to other countries, the Malaysian privatization programme has reflected its own objectives and priorities, as well as its administrative, legal and financial structures and therefore differs in many ways from the experience of other countries. One significant difference is that the proceeds from privatization have not been regarded as one of the primary objectives of privatization. They are regarded only as a bonus of privatization, unlike some countries which consider fiscal proceeds as a priority. The emphasis of the programme has always been on improving efficiency and productivity.

In the initial stages of privatization, Malaysia focused on the privatization of infrastructure, utilities, and assets enjoying strategic or monopoly positions. We prioritize and classify projects and entities to be privatized in order to expedite implementation. In addition, the Malaysian programme allows the private sector to play a significant role in initiating projects for privatization based on the principle of first-come-first-served. This approach has fostered a strong link between the Government and the private sector. It also

allows the nurturing and mushrooming of private sector entrepreneurs, particularly the local entrepreneurs, which is crucial in achieving the objective of transforming Malaysia into an industrialized country.

In Malaysia, due emphasis is given to the viability of privatization proposals, as only viable projects are privatized. In essence, the success of the Malaysian privatization programme is measured from the continued improvement of the privatized entities both in terms of efficiency and productivity. Projects which are not viable, and in cases where direct privatization may not receive full support initially, projects are converted to corporate entities at the initial stage of privatization. A corporatized entity fully owned by the Government is first transformed into a commercial enterprise under the Companies Act 1965. This step enables the agency and its workforce to adapt to a corporate work culture and transform it to a commercial entity having its accounts run on commercial lines. Examples of corporatized entities are the National Heart Institute, Postal Services Department and the ports of Penang and Bintulu. Although it will take longer for the corporatized entities to be privatized, the transition period is necessary in order to garner public support and to prove that such services are privatizable and will

bring benefit to the public.

B. Conclusion

Privatization has played a crucial role in accelerating the economic development of the country. Measured against the objectives of the programme, privatization has been successful as reflected by the increased efficiency and productivity of privatized entities. It has played a vital role in sustaining Malaysia's strong economic growth in the 1990s. Even though the current economic problems have affected the implementation of some projects, as a matter of policy, the privatization programme will be continued. There will be new areas and concerns in the policy in the future, which the Government will have to address and overcome. However, with vast experience gained over the years, remedial measures to overcome these problems will be undertaken to ensure the continued success of the programme.

XVI. PRIVATIZATION IN POLAND: MAJOR ISSUES, TRENDS AND POLICY CONCERNS

A. Introductory remarks

Effective privatization in a transition economy should be seen as one of the most fundamental success factors in the entire systemic transformation programme, aimed at replacing the former socialist, command economic system with a full-fledged market-driven economy, akin to those prevailing in Western industrialized countries. Unlike privatization programmes in the latter group, however, and, to a substantial extent, those being implemented in developing countries, privatization in the transition economies of Central and Eastern Europe has turned out to be a much more comprehensive process, both in terms of coverage and content. With regard to coverage, it is useful to make a distinction *between privatization of state-owned/public enterprises (SOEs) and privatization of the entire economy*. Privatizations in Western countries in the last two decades took place within the framework of well established market institutions (including predominantly private property rights) and were essentially confined to individual SOEs or their groups (at most to a few selected industries or sectors). Instead, in the former socialist

countries, ownership changes were aimed at encompassing the whole economy and dramatically transforming the entire property rights system in a relatively short time. Seen from this perspective, the spread of private ownership in these countries can be achieved by means of two parallel processes: (i) privatization of SOEs (so called 'top-down' or 'from above' privatization), and (ii) development of the private sector, through start-ups of new private businesses and/or expansion of existing private firms ('grass-roots' or 'bottom-up' privatization).

Simultaneously, privatization in transition economies has been much richer in content and it aimed to achieve a much broader set of objectives, compared to those in developed or developing countries. In the design of the transformation package, privatization was expected to become the most powerful vehicle of systemic change. This included not only direct effects such as ownership changes and the resulting efficiency gains. At the same time privatization was intended to bring about much desired spill-over impacts including the emergence of principal market institutions and appropriate behavioural patterns, either non-

existent at the outset of transition or severely distorted as a legacy from the command economy.

The purpose of the present paper is to provide an insight into the experience of Poland in the field of ownership changes, with special emphasis on new developments and issues arising in its privatization programme at the end of the 1990s. It also attempts to highlight the most pronounced trends in Polish privatization to date, including its main strengths and weaknesses. Finally, major policy concerns and challenges, as well as short- and medium-term privatization prospects, will be discussed. The main focus of our analysis will be on the narrower of the two concepts of ownership change, i.e. on government-led SOE privatization. However, wherever suitable, the assessment of the effectiveness of privatization policy will be carried out against the background of a more general process—privatization of the Polish economy.

The paper consists of four parts. Section B, that follows, provides a retrospective overview of privatization results and its most salient features for the entire transformation period, i.e. 1990-1998. In section C, new developments in this field as well as major policy challenges are discussed. In the concluding section privatization prospects are briefly outlined.

B. Privatization in Poland in retrospect

Initial conditions

Poland, like other post-communist countries, entered the road from plan to market with a heavy command economy legacy, in particular in terms of strong institutional and behavioural barriers impeding a smooth transition process (Rapacki and Linz 1992). Apart from this common body of initial constraints, three peculiar features of Poland's 'historical endowment' are worth stressing here for the sake of a better understanding of determinants of the subsequent privatization process, its nature and outcomes.

First, prior to 1989, Poland's agriculture had been predominantly private—75 per cent of land was owned by private farmers. One of the consequences was the fact that at the outset of transition the overall share of the private sector in the country's GDP and employment was the highest in all East-Central Europe (19% of GDP and 35% of employment in 1988, versus 15% in Hungary in terms of GDP and only some 2 to 4% in other socialist countries).¹¹ This may have given rise to two different impacts on the ensuing privatization process in Poland. In the first place, in strictly statistical terms, it could imply a slower pace for this process, compared to other transition economies which in 1990 started to build up their private sectors virtually from scratch. On the other hand, however, Poland's higher initial weight of the private sector in the economy may be interpreted as a potential comparative advantage in terms of its stronger exposure to microeconomic incentives compatible with the market mechanism and a greater available stock of entrepreneurial initiative.¹¹¹

Second, under the constraints of socialist ideology and the 'imperial cluster' ties with the Soviet Union, Poland has enjoyed since 1956 the

¹¹ Milanovic (1989), Gelb and Gray (1991) and Rapacki (1995). If co-operatives are included (they were transferred for statistical reasons from the public to private sector in 1990) the relevant indices for Poland would rise to 29% and 44.1% respectively (Rapacki 1995).

¹¹¹ This hypothesis seems compatible with the theory put forward by Baumol (1990).

highest relative openness in the Soviet bloc in terms of both the flow of ideas and, since 1971, of people. Soon after the Gierek group came to power in December 1970, Poles were allowed, with some restrictions, to travel to the West. For more than ten years, up to 1-2 million Poles used this new window of opportunity to undertake temporary jobs in Western countries. This may have enabled them to acquire new skills and work ethos, to get acquainted with key market institutions as well as to accumulate the initial capital to be invested later in the start-ups of their own businesses. In the view of some authors (eg. World Bank 1996), this factor may have significantly contributed to the unprecedented explosion of private entrepreneurship in Poland since 1989 and fuelled its fast macroeconomic growth.

Third, privatization appears to have suffered in efficiency terms from the institutional arrangements and behavioural consequences associated with Poland's unique labour-management relations. Traditions of labour management at the enterprise level in Poland date back to 1956. The 1981 Law on Workers' Self-Management (passed under strong Solidarity pressure) established a new type of vested interest of employees in state-owned enterprises. The Law split the property rights bundle between workers, management and the state (the so called Polish "Bermuda triangle"): workers and managers gained the right to use and benefit from use while the state as sole owner retained the right of exchange (Rapacki and Linz 1992). As a result, Polish privatization programmes since 1990 have had to reconcile the equity and efficiency objectives and

have tended to be biased towards employee interests. Simultaneously, since the Mazowiecki cabinet in 1989, all subsequent governments have had to bribe SOE workers in order to weaken their resistance to ownership changes. A carrot that has been devised and consistently used to this end took the institutional shape of a free packet of shares (up to 15%) of SOEs being privatized, given away to their employees (the 1990 Law on Privatization of State-Owned Enterprises with posterior amendments, and the 1993 Law on National Investment Funds and their Privatization).

Selected quantitative results

In the most aggregate terms, private firms contributed 67 per cent of Poland's GDP in 1997—up from 19 per cent in 1988. Based on preliminary and incomplete data, it can be estimated that in 1998 this share increased to some 68-69 per cent.¹¹¹¹ Simultaneously, out of the country's 16.2 million total manpower, by the end of 1997 two thirds were employed in the private sector and by the end of 1998 this ratio may have increased by one percentage point. Between 1990 and 1997 the number of jobs created in the private sector amounted to nearly 3 million whereas total employment in the public sector shrank by 3.15 million (GUS 1998).

The weight of private enterprise varied widely between sectors. On one extreme, in 1997 private firms contributed 97 per cent of value added in trade and repair, 95 per cent in construction, 90 per cent in agriculture, 78 per cent in hotels and restaurants and 77 per cent in manufacturing. On the other hand, in terms of value added, private business represented only 3 per cent in electricity, gas and water supply, 4 per cent in mining and quarrying, and 39 per cent in transport, storage and communications (GUS 1998).

The above aggregate indices reflect the general results of the privatization process of Polish economy, ie. both the 'top-down' and 'grass-roots' ownership transformations. To enable a more

¹¹¹¹ GUS (1998) and (1999); author's calculations.

precise assessment of the effectiveness of privatization policy, more detailed data on the effects of SOE 'top-down' privatization are necessary.

The Polish Government embarked on its first privatization programme in early 1990. Ownership transformation was then expected to be fast and smooth: the goal was to privatize 50 per cent of the initial number of SOEs (8,872 in mid-1990) by the end of 1992, a goal later postponed to 1995 (Lewandowski 1995). The programme has been based on a multi-track approach to ownership changes: three major privatization tracks (methods) were envisioned. They include: (i) the capital (or indirect) track,¹¹¹¹ (ii) direct (or liquidation of viable SOEs) path, and (iii) liquidation of insolvent SOEs. Table 1 gives an account of actual outcomes of privatization policy implementation during the past nine years.

Between mid-1990 and end-1998, out of the initial number of 8,872 SOEs, 6,168, i.e. 69.5% have been subject to ownership transformation. By the end of this period there remained 2,906 state-owned firms (32.7% of those in 1990). If we exclude former state farms taken over by the Treasury Agricultural Property Agency, the quantitative proportions between the three main privatization tracks are more or less balanced (capital track–30.6%, direct track–34.6% and liquidation track–34.8%).

By the end of 1998, privatization was effectively completed in 55 per cent of all non-agricultural SOEs, subject to ownership transformation. Contrary to initial government plans and expectations, it was the direct track that proved the most "productive" privatization method (98.0% of projects completed); the success ratio for the liquidation path was 42.5 per cent. whereas that for the capital track was only 17.7 per cent. However, if one bears in mind that since the beginning of 1999, 512 companies participating in the National Investment Funds (NIF) Programme have also been effectively divested to private owners, this latter ratio goes up to 54.7 per cent.

¹¹¹¹ Under this track the Mass Privatization (later renamed National Investment Funds) Programme was launched in 1995. This programme will be discussed separately later.

The total number of new private companies set up on the basis of either former SOEs transformed under the direct track or the assets of those liquidated due to insolvency arrived by end-1998 to 1,373. The overwhelming majority of these new entities (1,222) were labour-managed companies (employee- or management/employee-buy outs–M/EBOs).

The effectiveness of Poland's privatization policy, however, can also be evaluated from a different perspective. The number of former non-agricultural SOEs where ownership changes had been initiated but not completed amounted by end-1998 to 1,552. Together with 2,906 SOEs not yet subject to such changes this makes up a total of 4,458 firms still in the pipeline of privatization (ie. 50.2% of the 1990 number).

As a matter of example we will now briefly discuss two macroeconomic impacts of the 'top-down' privatization—its employment effect and its fiscal effect. As of end-1997, former SOEs either undergoing ownership transformation or already privatized employed 1,440,000 persons. Out of this total number, only 496,000 jobs were actually transferred to the private sector (completed privatization) (GUS 1998). This result of SOE privatization ought to be compared with the incremental 3 million new jobs created during 1990-1997 in the private sector. It turns out that grass-root development of private enterprise has been much more important as a source of employment effects in Poland during transition.¹¹¹¹¹¹

¹¹¹¹¹¹ This pattern will not significantly change even if we take account of privatization of NIF portfolio companies in 1999 and the resulting transfer of 309,000 extra jobs to the private sector (GUS 1998).

Table 1. Ownership Transformation of State-Owned Enterprises in Poland, 1990-1998.

Type of transformation	1990-98	1990 ^a	1991	1992	1993	1994	1995	1996	1997	1998
Total SOEs subject to transformation	6,168	130	1,128	1,401	1,271	791	485	385	288	289
Transformed into Treasury corporations	1,381	58	250	172	156	209	230	154	40	112
• Actually privatized under capital (indirect) track	244	6	22	23	47	36	26	24	44	16
Direct track	1,563	44	372	246	203	120	113	146	185	134
• Actually privatized	1,538	15	227	307	184	180	126	181	162	156
Liquidation (insolvency) track	1,570	28	506	263	294	155	133	85	63	43
• Actually liquidated	668	3	29	89	94	82	86	109	102	74
Treasury Agricultural Property Agency	1,654	-	-	720	618	307	9	-	-	-
Total number of SOEs actually privatized	2,450	24	278	419	325	298	238	314	308	246

a - since 1 August 1990.

Source: GUS (1998); *Dynamics....* (1998); Ministry of Treasury data.

Table 2. Budget Revenues from SOE Privatization, 1991-1998 (US\$ million)

	1991	1992	1993	1994	1995	1996	1997	1998
Total	175.3	355.4	430.1	701.8	1,089.6	1,390.6	1,993.2	2,020.0
- as % of budget revenues	0.8	1.5	1.7	2.5	3.2	3.8	5.5	5.6
Divestitures of SOEs	128.7	226.7	242.2	372.6	707.1	726.5	.	.

Liquidation	31.2	126.0	158.1	142.1	167.5	358.0	.	.
- leases and rentals	15.4	2.9	96.0	85.4	102.5	.	.	.
Divestiture of banks	-	-	29.7	187.1	215.0	306.1	.	.

Source: Report...(1994 and 1995); GUS (1998); Rapacki (1996), and own calculations.

As data in table 2 clearly demonstrate, proceeds from SOE privatization have steadily gained importance as a source of budget revenues. During 1991-1998 their cumulative stream amounted to \$6,183 million; simultaneously their share in total budget revenues increased seven-fold—from 0.8 per cent in 1991 to 5.6 per cent in 1998. What is worth stressing here is the fact that proceeds from ‘top-down’ privatization have displayed consistent growth (both in real terms in local currency and in dollars) *despite* a deceleration in the pace of ownership changes in physical terms in the last several years (table 1). This indicates a substantial rise in unit sales prices for SOEs being divested. Simultaneously, it may also reflect a shift in priorities embedded in privatization policy away from efficiency gains and general institutional change towards strictly fiscal objectives.

Salient features of Polish privatization

The Polish privatization programme has displayed several unique properties, both in its design and implementation. These, combined with the most pronounced trends entailed in the privatization policy, enable us to draw a tentative balance sheet of its major strengths and weaknesses.

Among the most important strengths the following are worth mentioning here.

- Versatility. Polish privatization policy has been based on a multi-track approach. This feature contributed to increase its flexibility and made it possible to customize privatization programmes and procedures to the specifics of particular sectors, industries or even firms.
- Each privatization project used to be carried out on an individual basis, taking account of the existing demand of potential investors and the standing of the SOE involved. As a result, ‘top-down’ ownership transformation in Poland has not been confined, as in most other transition economies, to a formal transfer of property rights to private owners but in many cases it entailed much broader and deeper changes at the microeconomic level.
- Due to its versatility, flexibility and tailor-made approach, the Polish privatization programme succeeded in ensuring that SOEs divested to new private owners were, compared to other transition economies, more responsive to market signals and better suited to cope with competitive pressure.¹¹¹¹¹¹¹ These effects tended to be particularly sizeable in firms privatized under the capital track, including NIF portfolio companies, and, to a lesser degree, those subject to management/employee-buy outs (M/EBOs) where in-depth restructuring took place prior to or parallel with privatization, and new corporate governance patterns compatible with the market environment were effectively implemented.
- Formal and informal transfers of productive assets from the state firms to private sector have been on a large scale. As a general rule, direct privatization and liquidation of nonviable SOEs was followed by setting up new private companies to make a more efficient use of these assets. But even more important, perhaps, was the feedback effect between ‘top-down’ and ‘bottom-up’ privatization. As a result of asset stripping and downsizing of SOE activities, large amounts of machinery, equipment and other resources flowed to private firms thus

¹¹¹¹¹¹¹ This claim can be supported with data on the financial performance of the major categories of former SOEs after privatization, compared to the entire corporate sector. For example, in 1997 the gross profit margin for the latter totalled 3.2%; at the same time it amounted to 6.3% for former SOEs privatized under the capital track and 4.9% for M/EBOs. Similarly, the net profit margin was 1.6%, 3.6% and 2.8%, respectively (GUS 1998). In 1998 these relations improved further: the gross profit margin amounted to 2.6%, 6.3% and 5.0%, and net profit margin to 1.2%, 4.1% and 3.1%, respectively (GUS 1999a).

further enhancing efficiency gains due to improved resource allocation. To some authors (e.g. Dabrowski 1996) this factor translates into the key explanatory variable for the phenomenal expansion of Poland's private sector after 1989.

- Privatization initiatives have as a rule come from SOEs themselves which implies employee acceptance. It may be argued that this factor could have contributed to reducing potential social conflicts due to ownership transformation in Poland (Report... 1997).
- A strength that needs a more extensive discussion stems from the design and implementation of the National Investment Funds (NIF) programme, also referred to as the Mass Privatization scheme. Despite its relatively limited scope (512 former SOEs representing some 8 per cent of sales and assets of respective sectors and industries) the NIF programme deserves the name of a genuine institutional innovation, as a novel, experimental vehicle for the effective privatization of the companies, coupled with their comprehensive overhaul and in-depth restructuring. Unlike similar mass privatization schemes in other transition economies (eg. The Czech Republic, Slovakia or The Russian Federation), the Polish NIF programme had institutional guarantees built in for effective enforcement of private-like ownership rights and corporate governance. In its design the programme has been a unique blend of the continental (the basic power structure of NIFs) and Anglo-Saxon legal systems (fund managers). Since their establishment in December 1994 until their ultimate privatization in January 1999, 15 National Investment Funds have for approximately four years remained wholly- and then majority-owned by the State Treasury. Based on civil contracts, the state owner hired private fund managers (predominantly private consortia of Western and Polish investment banks and business consulting firms) to perform the task of managing NIF assets, ie. 512 companies participating in the programme (34 to 35 per NIF). Thus, seen from this angle, the essence of the Polish NIF programme boils down to an effective privatization of the managerial function within each fund without formally transferring the ownership title to private owners. In other words, it consisted in a practical split of the property rights bundle between the State Treasury and fund managers, giving the latter the right to use and, at the level of portfolio companies, also the right to exchange. It was hoped that through this implant of private business incentives into formally state-owned entities (NIFs themselves and, indirectly, portfolio companies) both the funds and portfolio companies would start behaving like private agents and be more responsive to market signals. Empirical evidence suggests that these hopes have mostly come true (Rzeczpospolita 1999, NIF...1999). Despite a certain mismatch between general and employee expectations and reality¹¹¹¹¹¹¹¹ the NIF programme succeeded in bringing former SOEs much closer to the market and in making them much better prepared to withstand competitive pressure.¹¹¹¹¹¹¹¹

¹¹¹¹¹¹¹¹ Due primarily to very high expectations of portfolio companies' managements and employees. Empirical tests of these expectations have been carried out by Rapacki and others (1998).

¹¹¹¹¹¹¹¹ The most important outcomes of NIF and fund managers' activities during 1995-1998 can be summarized as follows (NIF... 1999):

- new private owners (mostly strategic investors) were found for 253 companies (out of 512), including 52 listed on the stock exchange,
- bankruptcy or liquidation of 34 companies,
- in-depth restructuring was carried out, in varying scope. in all 512 firms (including management, organization, finance, sales and marketing, manpower, downsizing, product mix and technology),
- new products were introduced in 455 companies, and 102 companies diversified into new activity,
- 461 companies embarked on new technologies and/or upgraded their existing equipment,
- new investment in NIF companies amounted to 1.8 billion zloty (\$0.5 billion),

The Polish privatization programme has also suffered from several weaknesses. The following are worth stressing.

- Excessive politization. Apart from increasing risk and uncertainty in microeconomic decision-making it also produced considerable delays in programme implementation. This in turn adversely affected the pace of ownership changes and effectiveness of privatization policy. To give but one example, the blueprint of a mass privatization scheme was ready in 1991; the relevant law was passed in April 1993 and the NIF programme was effectively launched in July 1995.
- The ‘top-down’ privatization was slower than initially expected in two respects. First, it failed to meet its quantitative targets, even in their relaxed form (50% of SOEs to be divested by end-1995). Second, it proved much less “productive” than the “grass-roots” ownership transformation, though this last trend may be seen less of a weakness of the former than as a strength of the latter.
- Contrary to first government plans and expectations, the direct and liquidation tracks (with M/EBOs as a dominant form of follow up), rather than SOE divestitures under the capital (indirect) path, turned out to be the most effective methods of privatization ‘from above’. Despite current good financial performance of most of labour-managed M/EBOs, however, one may fear the potential, longer-term threats endangering their economic viability. First, as a rule they are less effective in enforcing a corporate governance pattern compatible with market forces. Second, there tends to be conflict between short-term (wage maximization) and long-term (investment) objectives, in favour of the former. Finally, as empirical evidence has shown, the employee-managed companies in Poland have already faced capital constraint and suffered from the lack of sufficient investment funds (Dabrowski 1996).
- The foregoing trend, together with generous privileges for SOE employees built into the privatization laws (15% of free shares of eligible SOEs), combined to produce a strong bias towards the equity objective of ownership changes, and in particular towards employee interests. Seen from the economic perspective, this may be interpreted as an institutional and behavioural barrier to faster efficiency growth from privatization as well as a constraint on more effective corporate governance. Simultaneously, as some empirical studies demonstrate, employee-biased institutional arrangements in the Polish ownership transformation programme have tended to foster workers’ expectations to get even more of the privatization pie, thus reinforcing their resistance to change.¹¹¹¹¹¹¹¹¹¹
- Failure of successive governments until 1998 to extend their privatization programmes to cover ‘problem’ sectors and sunset industries such as mining, metallurgy, military equipment, power generation, and transport, including in particular railroads and national airlines. These sectors remained for several years without micro- and meso-economic restructuring, proper management, well defined ownership and were not exposed to market incentives. They continued to generate growing losses and contributed to aggravate Poland’s social problems and fiscal position. Privatization policy has also failed till recently to consistently bring about ownership

-
- the ratio of companies generating profits increased from 40% in 1995 to 64% in 1998.

¹¹¹¹¹¹¹¹¹¹ In a survey conducted by the present author in NIF portfolio companies, their employees declared that a fair amount of SOE shares offered free to workers should be approximately 30%, ie. twice the packet stipulated by privatization laws (Rapacki and others, 1998).

transformation in viable sectors with monopolistic market structures (eg. TP S.A. in telecommunication) or those with loose oligopolies in certain market segments (PKO BP in banking).

A. Recent privatization trends and major policy concerns

As can be seen from table 1 in the preceding section, the pace of SOE privatization slowed down in Poland in the last few years. The most pronounced deceleration occurred in 1998 when the number of SOEs in all categories embraced by 'top-down' ownership transformation was the lowest since 1990. This trend was accompanied by further delays in the privatization of such sectors as sugar processing, military equipment, metallurgy and heavy chemicals. Moreover, the key government agency responsible for the implementation of privatization policy, the Ministry of Treasury, appeared to display excessive risk aversion in taking relevant privatization decisions (Lewandowski 1999).

Even if this assessment is fair and correct in quantitative terms, the year 1998 can be deemed a turning point in terms of government commitment and approach to ownership changes in Poland. Parliamentary elections that took place in the fall of 1997, brought to power a new, Solidarity-rooted government coalition with Leszek Balcerowicz back to office as Finance Minister. Throughout 1998 the new cabinet took several important initiatives and embarked on a number of crucial institutional projects that either directly or indirectly should enhance the privatization process in the near future. Several underlying facts seem to support this claim.

- For the first time since the transition started, the Government succeeded in 1998 in designing and implementing a workable plan aimed at an in-depth restructuring of the coal mining industry, including sizeable lay-offs and downsizing, and making it a viable industry by 2002. As part of the plan, economically sound coal mines are to be divested to private owners from 1999.
- The general strategy and approach to ownership changes in metallurgy were worked out. Within the framework of this strategy, the two largest Polish steel mills were expected to be sold to foreign strategic investors in 1998 but due to unsatisfactory terms in their offers privatization was postponed.
- Privatization has started in the power generation sector. In 1998, two electricity and heat-generating stations were divested to private owners.
- As a first step towards subsequent privatization of the fuel and gas industry, the Government embarked on a project aimed at creating a large national gas company as a derivative of a merger involving the largest Polish gas distributor (CPN) and the country's top oil refinery (Petrochemia Plock).
- Ownership changes have been also initiated in telecommunication. In the first stage the minority stake of the Polish monopolist in this sector, TP S.A., was floated on the Warsaw Stock Exchange.
- Two major commercial banks, PeKaO (the second largest in Poland) and BPH, made initial public offerings and entered the stock market. With these developments, despite the fact that the State Treasury still retains a substantial part of the banks' equity, the Polish banking sector became predominantly privately-owned.
- Since 1 January 1999, Poland's Mass Privatization (NIF) Programme has entered its new, final phase. Its essence boils down to a formal, full-fledged privatization of all 15 National Investment Funds and, by the same token, of NIF portfolio companies not previously divested. The State Treasury has retained a minority stake (16% of NIF equity) while the new private owners that have already emerged (mostly foreign and domestic institutional investors) will soon start executing their property rights in each NIF and pertinent company.

- Last year was also a cornerstone for the long-awaited pension system reform. The Polish parliament passed the set of appropriate laws and since the fall of 1998 a dozen licences have been granted to private pension funds. The new pension system, based mainly on the patterns successfully tested in some Latin American countries (Chile, Argentina and Mexico), was launched in January 1999 and will become fully operational from April 1999. Its implementation entails the emergence of a new category of institutional investor in the Polish capital market and simultaneously a rising share of the private sector in the economy. From the angle of our analysis, one more likely impact is worth highlighting. The new system, with the key role of private pension funds operating in the capital market, is bound to mobilize new streams of personal savings and thus *inter alia* fuel the growth of the Warsaw Stock Exchange. By the same token it will provide a new impetus to SOE privatization, in particular under the capital track.¹¹¹¹¹¹¹¹¹¹

Two more issues should be mentioned while discussing the most salient recent developments in Polish privatization. They both illustrate major concerns the Government has had to face in pursuing its privatization policy. First, last year witnessed mounting grass-root pressure in the trade union-dominated leading coalition party to embark on a mass-scale programme aimed at a free distribution of ownership titles to the remaining state property to society at large. If a blueprint of this programme, designed and tabled with the Parliament by a group of radical MPs gets accepted and implemented, this would significantly strengthen the equity bias in Poland's ownership transformation and adversely affect the efficiency objective.

The second policy concern is due to a growing gap between the total book value of the outstanding state assets eligible for privatization and the combined funding requirements to be covered by privatization proceeds, and the even greater gap with the market value. The requirements in question stem from crucial systemic reforms under way (pension system, health care, education and local government) and past government commitments towards some groups of Polish society (delayed compensation of public sector employees, and restitution of nationalized property to pre-war owners).¹¹¹¹¹¹¹¹¹¹

A. Short-term prospects

Looking ahead, the coming years should bring several new important developments in the field of privatization in Poland. The projection that follows is based on both explicit government plans and the extrapolation of the recent most pronounced trends discussed above. These developments include, in particular:

- Privatization (in 1999) of the first two viable coal mines (Bogdanka and Budryk). Simultaneously, as a result of the government recovery plan launched in 1998, the economic viability of the whole coal mining sector will gradually start improving to cross-over the break-even point by 2002.

¹¹¹¹¹¹¹¹¹¹ A recent empirical study estimated that a new stream of personal savings due to the launching of a new pension system may amount to 9.7-10.4 billion zloty annually in 1999-2001 (in constant prices). It would then be equivalent to 28-30% of the total 1998 stream of household savings in Poland (Rapacki and others, 1998a).

¹¹¹¹¹¹¹¹¹¹ According to estimates by the Ministry of Treasury and independent economists, the restitution claims of former owners may range between 130 and 190 billion zloty, ie. exceeding the book value of the outstanding state productive assets (Rzeczpospolita 1999a).

- Implementation of the privatization strategy with regard to the two largest Polish steel mills (Katowice and Sendzimir Mills) and their subsequent divestiture to strategic foreign investors (1999-2000).
- Privatization of six electricity and heat-generating stations as well as three large power stations, combined with possible mergers among other domestic power suppliers prior to their privatization (1999).
- Completion of the merger of two largest players in the gas and fuel sector (CPN and Plock Refinery); shares of the new company will be floated on the Warsaw and London stock exchanges (1999). The second-largest Polish refinery (Gdansk) is also to be sold to a foreign strategic investor.
- The decisive stage in the process of privatization of Poland's telecommunication monopoly, TP S.A., will be finalized. Between 25 and 35 per cent of its shares will be sold to a private strategic investor (1999). Simultaneously, the telecommunication services market will be opened more widely to domestic and foreign competition.
- Divestiture of the second-largest commercial bank in Poland (PeKaO S.A., whose minority shares entered the stock market in 1998) to strategic investors (1999). The Government also plans to start the privatization process of the largest bank in the country, PKO BP. This process is to be completed by end-2000.
- Privatization of the largest state-owned insurance company, PZU S.A. (1999). If successful, it would dramatically increase the market exposure of the entire insurance sector and change the incentive structure guiding the competitive behaviour of players involved in the Polish market.
- Elaboration of workable privatization strategies in three sectors—sugar processing, military equipment and liquor industries. Their ownership transformation is expected to begin in 2000 and take one to two years.
- Follow up of the 'top-down' privatization in the pharmaceutical industry. In 1999 two major pharmaceutical SOEs (Polpharma in Starogard Gdanski and Polfa Tarchomin) are scheduled for divestiture.
- A two-fold increase of the budgeted privatization proceeds in 1999 (to some 4 billion dollars compared to 2 billion in 1998). If this target is met, it should create an important feed-back with the pension system reform underway providing a sizeable financial cushion for its start-up costs (the budget law for 1999 envisions supporting the new system with some 27 per cent of privatization revenues, ie. approximately 1.1 billion dollars).
- In view of the new emerging ownership structure of National Investment Funds, the prospects of this innovative mass privatization scheme are not quite clear. Based on public statements and less official hints of some of the new owners (representatives of

- foreign investment funds), two changes seem almost certain in 1999. First, some of the 15 NIFs will be merged to ensure economies of scale. Second, with the end of cost economies, the new owners will either sack some of the fund managers or make them perform the task in more than one NIF at a time. It is also quite likely that, depending on any changes in the present strategies of individual NIFs, further restructuring of the bulk of portfolio companies (in particular the nonviable ones) might be endangered (Bochniarz and Wisniewski, 1999). Three distinct strategies with regard to NIFs and portfolio companies seem feasible under the new ownership structure: (1) the strategy of aggressive cashing of shareholder value. This will consist in a fast winding up of NIF activities through sales of the best-performing companies and withdrawal of liquid assets. At the same time it will entail freezing of restructuring efforts in non-performing firms; (2) the strategy of gradual winding up of NIF operations and their eventual liquidation in the longer run. Its main components will encompass redemption of a part of equity, a high pay-out of dividends and a substantial reduction of fund managers' fees. If this is compatible with the objective of shareholder value maximization, the new NIF policies may not rule out either some restructuring in portfolio companies or using the stock market as a vehicle for their divestiture; and (3) the strategy of NIF transformation into classical venture capital funds. This will involve a growing share of investments outside the original group of portfolio companies and thus may produce dynamic synergistic effects with government privatization policy. This scenario seems more likely in the case of those NIFs which have already embarked on a similar policy and proved both capable and effective.
- The foregoing possible scenarios give rise to a new policy concern for the State Treasury. In the new circumstances, the Government should take a better care of the interests of minority shareholders in the NIFs. Parallel to that, it ought also to devise a new set of policy measures aimed at ensuring the realization of one of the key objectives of Poland's mass privatization programme—to continue an in-depth restructuring in nonviable former SOEs and to make them ready to cope with market forces in a competitive environment.

References

- Baumol, William J. (1990), Entrepreneurship: Productive, Unproductive and Destructive. *Journal of Political Economy*, vol. 98, No. 5.
- Bochniarz, Henryka and A. Wisniewski (1999), *The Hour of Truth*, (in Polish). "Rzeczpospolita", 5 February.
- Dabrowski, Janusz (1996), "Effects of Privatization of Polish State-Owned Enterprises", in: R. Rapacki (ed.), *Enterprise Culture in a Transition Economy: Poland 1989-94*. Warsaw: UNDP-Warsaw School of Economics.
- Dynamics of Ownership Transformations* (1998), No. 39. Ministry of Treasury, Warsaw, December (in Polish).
- Gelb, Alan H. And Cheryl W. Gray (1991), *The Transformation of Economies in Central and Eastern Europe: Issues, Progress and Prospects*, Policy and Research Series, No. 17. Washington, D.C.: The World Bank.
- GUS (1998). Central Statistical Office (GUS), *Statistical Yearbook 1998*. Warsaw (in Polish).
- GUS (1999). Central Statistical Office, *Statistical Bulletin*, No. 12, January, Warsaw.
- GUS (1999a). Central Statistical Office, *Information on Social and Economic Situation of the Country in 1998*, 28 January, Warsaw.
- Lewandowski, Janusz (1995), An Overview of Polish Privatization Process, in: G. Blazyca and J.M.Dabrowski (eds.), *Monitoring Economic Transition. The Polish Case*. Averbury.
- Lewandowski, Janusz (1999), Interview with the former Privatization Minister. *Gazeta Wyborcza*, 4 February.
- Milanovic, Branko (1989). *Liberalization and Entrepreneurship: Dynamics of Reform in Socialism and Capitalism*. Armonk, NY: M. E. Sharp, Inc.
- NIF Association (1999), NIFs' Successes and Failures (in Polish). Presentation at a conference on National Investment Funds. The Facts and the

Future. Warsaw, 27 January.

Rapacki, Ryszard (1995), Privatization in Poland: Performance, Problems and Prospects. *Comparative Economic Studie*”, vol. 37, No. 1, Spring.

Rapacki, Ryszard (1996), *Privatisation and the Public Exchequer in Poland*. Working Paper No. 151. World Economy Research Institute, Warsaw School of Economics.

Rapacki, Ryszard, and Susan J. Linz (1992). *Privatization in Transition Economies: Case Study of Poland*. Econometrics and Economic Theory Papers, No. 9011. Department of Economics, Michigan State University.

Rapacki, Ryszard, K. Skoczylas and P.Kulesza (1998), *The NIF Programme in Employee Perception. The Findings of a Survey in NIF Portfolio Companies* (in Polish). “*Ekonomista*”, No. 4.

Rapacki, Ryszard, Z.Matkowski, J.Prokop, P.Jaworski, P.Maszczyk and M.Prochniak (1998a), *The Analysis and Forecast of Personal Savings in Poland from the Angle of Investment Funds' Development Prospects* (in Polish). Warsaw School of Economics, Warsaw, November.

Report on Ownership Transformations in 1993 (1994). Ministry of Ownership Changes. Warsaw (in Polish).

Report on Ownership Transformations in 1994 (1995). Ministry of Ownership Changes. Warsaw (in Polish).

Report on Ownership Transformations in 1996 (1997). Ministry of Treasury. Warsaw (in Polish).

“Rzeczpospolita” (1999). *To Continue or to Wind Up?* 28 January (in Polish).

“Rzeczpospolita” (1999a). *The outstanding assets may not suffice*. 27 January (in Polish).

World Bank (1996), *World Development Report 1996. From Plan to Market*. Washington, D.C.

LIST OF PARTICIPANTS

Paper presenters (in order of presentation)

Mr. Constantine Vaitsos, Professor, Department of Economics, Athens University
 Mr. G.B. Opoku, Executive Director, State Enterprise Commission, Government of Ghana
 Mr. Leroy Phoenix, National Investment Bank of Jamaica
 Ms. Hanifah Hassan, Director, Privatization Section, Economic Planning Unit, Prime Minister's
 Department, Government of Malaysia
 Mr. Ryszard Rapacki, Warsaw School of Economics, Warsaw, Poland
 Mr. Mark Dutz, The European Bank for Reconstruction and Development,
 London, The United Kingdom
 Mr. David Hale, Chief Economist, Zurich Insurance Group, Chicago
 Mr. Ahmed Galal, Adviser, The World Bank, Washington D.C.
 Mr. Digambar Bhouraskar, Baruch College, City University of New York
 Mr. Christian Schiller, Deputy Chief, Expenditure Policy Division, Fiscal Affairs Department, IMF,
 Washington, D.C.
 Mr. Max Iacono, Senior Specialist, ILO, Manila, The Philippines
 Mr. R. Shyam Khemani, Group Manager, Business Environment Division, The World Bank, Washington
 D.C.
 Mr. A. Horn and Ms. S.R. Kim, Public Policy Analysis and Development Branch, DESA
 Ms. Tessie San Martin, Director, Pricewaterhouse Coopers, Arlington, Virginia
 Mr. Tony Bennett, Public Finance and Private Sector Development Branch, DESA
 Mr. Keith Hillyer, REDMA Consultants, Missisauga, Canada

Other participants

Mr. Guido Bertucci, Director, Division for Public Economics and Public Administration, UN-DESA
 Mr. Abdel Hamid Bouab, Chief, Public Finance and Private Sector Development, DPEPA, DESA
 (Chairman)
 Mr. David Gold, PPADPB/DESA
 Ms. Najet Karaborni, GPAB/DESA
 Ms. Sabine Gauthé, PFPSD/DESA
 Mr. Fadhil Mahdi, PPAD/DESA
 Mr. Michael Mimicopoulos, PFPSDB/DESA
 Mr. Masa Ohyama, PFPSDB/DESA
 Mr. A. Padova, DBAD/DESA
 Mr. K. Sharma, SEPTFD/DESA
 Ms. Leslie Wade, OSCAL, DESA

Mr. Sergei Zelenev, DSPD/DESA

Mr. Thomas Richardson, Senior Economist, IMF, Washington D.C.

Mr. Gordon E. Thompson, Consultant, Washington

Support Team

Mr. Abdel Hamid Bouab, PFPSDB/DESA, (Chairman)

Mr. Tony Bennett, PFPSDB/DESA (Rapporteur)

Ms. Veda Gittens, NOC/DPEPA/DESA (Administration)

Ms. Janet Echevarria, PFPSDB/DESA (Secretarial Assistant)