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Introduction to

Privatization: Successes and Failures

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INTRODUCTION

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Privatization of large state-owned enterprises has been one of the most radical new policies of the last quarter century. While many countries had engaged in large nationalization programs during the decades following World War II, Margaret Thatcher initiated a policy swing in the other direction in the 1980s by pushing for aggressive privatization of many of the large state-owned British firms. In the following two decades, privatization policies were implemented throughout the planet, as both left and right leaning governments alike undertook a policy of privatization. Right wing governments engaged in privatization in an effort to keep down the size of government, while Left wing governments implemented privatization policies in order to generate revenues, and also because they were persuaded of the virtues of markets and competition after being disappointed with the inefficiencies of large state-owned firms. In this way, privatization spread from Europe to Latin America, Asia and Africa, reaching a high point with the transition from socialism to capitalism following the fall of the Berlin wall. Transition economies were then faced with the task of privatizing their whole economies. In theses cases, quite diverse policies were put in place, ranging from a gradual sale of state property to foreign and domestic investors (as was the case in Hungary and Poland) to more radical programs called “mass privatization programs” which resulted in the rapid giveaway of state owned assets.

Privatization policies generated huge controversies. In many countries, they were criticized for their regressive redistribution effects. State ownership in many countries was used as a tool of redistribution that made it possible to provide cheap water, energy or transport for poorer segments of the population. Privatization has thus been associated with cutbacks in redistribution and has stirred popular discontent in many countries. Privatization programs were also systematically criticized for the rents they generated among the acquirers of state assets. Mass privatization in Russia, for example, fell under attack for fabulously enriching in a very short period a small group of very powerful oligarchs. Accusations of corruption and cronyism have stained the reputation of privatization programs in many countries. More blandly, the efficiency improvements expected from privatization have often been hard to detect or altogether absent.

. In the spirit of the mission of the Initiative for Policy Dialogue, this volume, developed by the IPD Privatization Task Force, brings together some of the world's foremost experts on the subject. In the following essays, the contributors present their knowledge about privatization, not just for an academic world, but also for a far wider audience. It would be presumptuous to assert that every single topic is covered, but the reader will find in this volume a comprehensive overview of the issues associated with privatization, as well as a coverage of specific privatization projects undertaken in different continents.

One of the main reasons that privatization programs were first pushed forward is the disappointment with the economic performance of state-owned enterprises. It might appear to the outside observer uncontroversial that the proposition that private ownership is economically more efficient than state ownership. Yet this has not been the case in economic theory. In this volume, Gérard Roland reviews the economic literature on private and public ownership. Citing in particular general equilibrium theory—one of the central components of economic theory—Roland explains how ownership of firms plays no role at all, provided the latter act in a manner that maximizes their profits. What matters most is that firms face a perfectly competitive environment. In traditional industrial organization theory, there is *a priori* not much difference between a natural monopoly under government ownership or under private ownership with government regulation. It has really only been in the last decades—with the advent of contract theory—that one has been able to pin down differences between private and public ownership in the context of imperfect competition. One branch of contract theory, complete contract theory, emphasizes the differences in information under public and private ownership and how they affect the incentives of the firms. Incomplete contract theory attaches great importance to ownership as residual rights of control in situations not provided for by the contract. The picture that emerges is that private ownership gives better incentives to invest, to innovate, to reduce costs and to reduce inefficient government intervention in firms. On the other hand, this higher efficiency may come at the cost of quality and other socially valuable objectives and may even increase corruption within government. The analysis of the tradeoffs between public and private ownership have become more sophisticated. Interestingly, many of the tradeoffs pointed to by these theories can now be observed in the actual experience of privatization.

Western Europe is the world leader in privatization revenues with roughly a third of privatization proceeds over the period 1977-2002. Bernardo Bortolotti and Valentina Milella remind us that Western Europe also implemented extensive nationalization programs after World War II. Later, when the UK initiated a large privatization program under Margaret Thatcher, continental Europe also experienced large programs of divestiture of state assets. High privatization revenues are associated, not surprisingly, with high per capita GDP and large and liquid stock markets, but they are also associated with a higher public debt and lower growth. The latter findings suggest that concerns for fiscal imbalances and deterioration of economic performances might have played an important role in triggering privatization programs. Privatization efforts were greater in countries with a majoritarian electoral rule. Interestingly, all else being equal, left wing governments do not appear to have privatized less than right wing governments. Surprisingly, there is scant evidence as to the macroeconomic effects of privatization in Western Europe. The only solid evidence found is the negative impact of privatization on public debt, not an unexpected result. Privatization is associated with a vigorous financial market development. It is also associated with better performance at the level of individual firms. However, the empirical evidence is often not convincing because it compares the performance of firms that were privatized with others that were not. The performance effect might reflect the fact that those enterprises that were privatized were either the most profitable or had the highest potential for profitability. There are as yet too few studies measuring correctly the causal effect of privatization on enterprise performance. An especially interesting finding reported by Bortolotti and Milella is that a large part of privatization deals (at least 30%) led to the divestiture of only a minority of shares of state-owned firms. Yet, governments have kept sizable residual stakes in privatized firms and appear reluctant to lose their control over state assets. These interesting findings are quite recent and will undoubtedly be investigated in future research.

The most spectacular privatization experience is undoubtedly the one that took place in the transition process from socialism to capitalism in Central and Eastern Europe. Jan Hanousek, Evzen Kocenda and Jan Svejnar review this historical phenomenon. They insist that privatization policies must be seen within the general context of the transition strategy adopted in each country, including the relative role given to privatization of large state-owned firms and to the development of a new private sector. Economists were deeply divided between those who on the one hand advocated a very rapid privatization relying on giveaway schemes—the so-called mass privatization programs, and those who, on the other hand, advocated a more cautious approach based on the gradual sale of state assets. The literature abounds with various schemes on how to implement one of these two approaches. Countries like Poland, Slovenia, Estonia and Hungary adopted the gradualist approach. Russia, the Ukraine, the Czech Republic, Lithuania and, to a certain extent, Slovakia adopted forms of mass privatization programs. Within that general classification, the details of the programs varied from country to country. The few studies on the determinants of privatization suggest that the more profitable firms were privatized first, which is consistent with political economic theories of privatization where the sequencing of privatization is used to gather support for further privatization. But there is astonishing diversity in the results of the studies on the effects of privatization firm performance. Many studies were made very shortly after privatization first occurred. Other studies relied on rather rough measures of ownership noting only a public-private distinction and could not measure differences in ownership structure and corporate governance. Many studies suffer from a selection bias already alluded to. If the more profitable firms were privatized first, superior performance in those firms cannot be causally attributed to privatization. The studies that correct for this bias generally find more modest effects of privatization. The strongest effects seem to be reached in cases of where state assets where sold to foreign owners. Employee and manager ownership rarely has a significant positive effect on firm performance—be it total factor productivity, labor productivity or profitability. The survey by Hanousek, Kocenda and Svejnar is quite thorough in terms of the performance variables analyzed.

John Nellis gives a careful overview of privatization policies and their effects in Africa. African governments have as a rule not wholeheartedly embraced privatization of state-owned enterprises. Only a minority of state-owned enterprises have been subject to privatization in most African countries. Very little privatization has taken place outside of the following five countries: South Africa, Ghana, Nigeria, Zambia and Cote d'Ivoire. Infrastructure is the sector where one finds the largest state-owned enterprises in Africa but privatization in that sector has lagged behind. When privatization does take place, the government usually keeps a significant ownership share. In Africa there is much less evidence regarding the effects of privatization, than in Europe, and the evidence, scarce as it is, is at best mixed. Privatization in Cote d'Ivoire seems to have had positive effects on firm performance. A similar picture emerges from Ghana. However there are many caveats. Positive effects seem to be observed only when privatization is associated with enhanced competition and a better quality of regulation. There is also evidence of rent-seeking, regulatory capture, reduction in affordability of public services, and a loss of jobs—all of which further feeds resentment within the country and increases the reluctance of African governments to go further along the route of privatization. Nellis argues that even when negative effects are observed, it is not obvious that the counterfactual—namely the absence of privatization—would have delivered better results. This is due in part to the general deterioration of public services and of the economy in general in many countries. The poor performance of privatization has in the Eastern European context often been attributed to weakness in institutions. This is likely to be even truer in Africa. However, it is not realistic to expect large institutional changes in Africa in the medium run. Nellis explores possible solutions to this problem such as the outsourcing of institutional provision, and the use of offshore commercial arbitration mechanisms or of NGOs to vet transactions. However, few of these solutions are likely to find much political support. It appears that the return of Africa to a path of growth and development cannot, in the near future at least, rely too much on privatization.

Chile was one of the first countries to start a large-scale privatization program. Chile began privatizing in 1974 after the Pinochet coup—many years before Thatcher started privatizing in the UK. In the later eighties and early nineties, many other Latin American countries also engaged in extensive privatization. Bolivia, Peru, Brazil, Argentina and El Salvador, for example, all launched quite ambitious privatization programs. Antonio Estache and Lourdes Trujillo details Latin America's diverse experience with privatization and gives a country-by-country account of its privatization policies. Privatization of infrastructure plays a special role in Latin America, pointing to politically delicate distributive issues such as access to water, electricity and public transport. Indeed, it was only under extreme fiscal strain that large infrastructure privatization programs were launched. Because of fears of political backlash, assets were generally leased instead of sold and concession contracts were widely used. Nonetheless, this has not prevented some forms of political backlash when, on several occasions, electricity or water shortages emerged. What has privatization achieved in Latin America? It seems to have been an effective tool to generate revenues. Moreover, overall we have seen a strong flow of investment in the privatized firms. Privatized firms have in general improved their profitability and productivity. Gains are mostly present in regulated sectors, rather than in firms in competitive sectors. Estache and Trujillo also reminds us that privatization often had quite a positive impact on the quality of goods and services in the privatized firms. In these cases, improvements were initially welcomed by the population and generated support for privatization. So, why has political support for privatization disappeared in recent years? One reason is that privatization has rarely put an end to subsidies or to government investment in the sectors concerned. While privatization has generated a stock of revenues, it has often not reduced the flow of government expenditures in the privatized sectors. Another reason why support for privatization has subsided relates to the redistribution of gains. Privatization has generated large rents for new owners but these have not been shared with the general public. There are cases such as the Cochabamba water concession in Bolivia where the poorer segments of the population faced price increases for water. This is due to regulatory failure resulting, most often, from regulatory capture. Despite the organization of competitive bids, in practice, there has been very little competition between bidders. The reason for this is not clear but might be due in part to collusion between private firms. It might also be a result of extreme international concentration in some markets. Related to the weakness of competition is the fact that many privatization deals were renegotiated only a few years after the initial privatization took place. This often led to higher prices and more rents for the private owners. Restructuring in privatized firms has led to job losses that were quite salient. For example, in the international sanitation business (water, sanitation and solid waste), the same five large companies have been involved in all privatization deals the world over.

Despite its strong economic dynamism, the Asian continent has not been at the forefront of the world's privatization efforts. This is especially the case for South Asia (Bangladesh, India, Pakistan and Sri Lanka). Nandini Gupta analyzes the experience of privatization in these countries. India, after its independence, developed a sizable public sector and adopted some form of central planning. But after the collapse of central planning in the former socialist economies, India's reforms efforts also gained strength. However, privatization achievements remained modest. Until very recently, most privatization was partial and consisted of the divestiture of minority shares in public enterprises. Nevertheless, Gupta gives extensive evidence that partial privatization has had positive effects. The floating of shares on the stock market has allowed for improvement in the monitoring of management. Privatization has also had a positive effect on the development of stock markets. Yet, limited capacities of financial markets as well as limited administrative capabilities and political obstacles have constrained the speed of privatization. An important reason for the reluctance of politicians to privatize is that state-owned enterprises are used for political patronage. Privatization therefore tends to be slower in provinces where there is sharp political competition.

Finally, the subject of privatization has been very controversial. The last chapter of this volume summarizes the perspective of one of privatization's most vocal critics, Jomo K.S. He puts the current debate in historical context, and cites the literature providing evidence of how privatization may not have had as positive effects on efficiency as its advocates claim, even aside from its adverse equity implications. He also shows that due to these revealed deficiencies, the debate over privatization has evolved over time.

Overall, some common themes emerge from the various contributions to this volume. First of all, partial privatization tends to be more widespread than one might think. Governments in Western Europe, India and elsewhere are reluctant to relinquish control (partly or fully) over state-owned enterprises. This is not surprising but is still an important fact that has emerged from the privatization experience of the last decades. Whether partial privatization has beneficial effects or not depends on many factors and one should be wary of making sweeping generalizations. Partial privatization may enhance the monitoring of enterprises but it may also keep alive inefficient forms of government intervention. The efficiency effects of privatization are generally mixed but rarely negative. This is true even though many empirical studies tend to overestimate the efficiency effects due to sample selection bias that has plagued many econometric estimation of privatization. While privatization appears uncontroversial in competitive sectors (even though its effects may be small in relation to the incentive effects of competition), it becomes increasingly complex in more monopolistic sectors where good regulation is a necessary and crucial complement to privatization. However, creating good regulation is easier said than done. There is a real danger (documented in particular in the chapters on Africa and Latin America) that privatization will lead to a form of regulatory capture that generates large rents for the new private owners while creating welfare losses for consumers. This can especially harm the poorest segments of the population that may be hurt strongly by the regressive redistributive effects often generated by privatization. Calling for better regulation might be illusory because it would require a major institutional overhaul that is not in the cards in the immediate future. Thus, policymakers involved with privatization often face a large dilemma: be cautious with privatization and face the continued inefficiencies of state-owned enterprises with the prospect of further deteriorations or be bold and risk major political backlash because of the redistributive effects of privatization, especially if rent-seeking and regulatory capture are involved. This is a steep trade-off. However, in the larger context of development, focusing on the restructuring of large state-owned enterprises, by privatization and the complementary policies, might prove to be misguided. Statist policies of development have focused on the creation of large state-owned enterprises in the hope that this would lead developing economies to close the gap between themselves and the developed economies. Liberalization policies based on the Washington Consensus have also focused on these large enterprises hoping that the transfer of ownership to the private sector would foster accelerated growth in the economy. The privatization policies of particular countries might however at best have had second-order effects on growth. Countries that have experienced impressive growth in recent years such as China, India and Vietnam have not had an impressive privatization policy. Rather, they have been able to unleash the productive energies of millions of small entrepreneurs, creating a vibrant and thriving sector of small and medium enterprises which serve both the domestic and the export market. One would hope that international financial organizations pay as much attention to the development of the small private sector as they have to privatization policies in the past.