An Assessment of Privatization

Sunita Kikeri • John Nellis

Mounting empirical evidence of privatization's benefits coincides with increasing dissatisfaction and opposition among citizens and policymakers. This dissatisfaction reflects the growing questioning of the benefits of privatization, the general downturn of global markets in the past few years and the resulting swing of the pendulum back toward increased governmental supervision, the overselling of privatization as a panacea for all economic problems, and the concern that privatization does not produce macroeconomic and distributional gains equivalent to its microeconomic benefits. This article takes stock of the empirical evidence and shows that in competitive sectors privatization has been a resounding success in improving firm performance. In infrastructure sectors, privatization improves welfare, a broader and crucial objective, when it is accompanied by proper policy and regulatory frameworks. The article argues that despite the growing concerns privatization should be neither abandoned nor reversed. Rather, there should be a strengthening of efforts to privatize correctly: by better tailoring privatization to local conditions, deepening efforts to promote competition and regulatory frameworks, enforcing transparency in sales processes, and introducing mechanisms to ensure that the poor have access to affordable essential services.

Almost every country is divesting some or all of its state enterprises to the private sector or involving the private sector in managing and financing activities previously owned and operated by the state. The reasons for privatization are well established. Especially in developing economies and in infrastructure and network industries, state enterprises have proved wasteful and inefficient, producing low-quality goods and services at high cost. Sheltered from competition, state enterprises were often overstaffed and required to set prices below costs, resulting in financial losses that in acute cases amounted to as much as 5 to 6 percent of gross domestic product (GDP) annually. Bailouts and fiscal strains resulted. Covering state enterprise losses through fiscal transfers required governments to finance larger fiscal deficits and increase tax revenues or reduce public spending in other areas, or both. Financing

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losses through the state banking system reduced the private sector's access to credit and threatened the viability of the financial sector. Many governments became incapable of providing capital to their state enterprises, even profitable ones, for maintenance and repair, much less for badly needed expansion and renewal.

Attempts through the 1970s and early 1980s to impose hard budget constraints, expose state enterprises to competition, and introduce institutional and managerial changes yielded meager improvements in performance. Some effects looked promising (for example, in New Zealand) but proved unsustainable. Backsliding was common, and the poorer the country, the quicker and deeper the reversal. By the middle of the 1980s, following the powerful lead of the Thatcherite revolution in the United Kingdom, government ownership itself came to be seen as a principal reason for the inability to effect major and enduring state enterprise reform. In industrial countries, the shift to private ownership was motivated in equal parts by the failures of reforms short of ownership change, a sea change in ideology, and the short-term fiscal attractions of selling state assets. In developing economies, the impetus was much more financial and fiscal. With the international financial institutions leading the way, privatization was vigorously promoted as a tool to reduce the budgetary burden caused by state enterprise inefficiencies and, in the case of infrastructure, to improve performance and access to investment capital for modernization and expansion of networks.

Despite the widespread adoption of privatization and the positive economic assessments of what privatization could do, a number of critics—sometimes including the general public—have expressed strong reservations about privatization's fairness and sometimes its efficiency impact. Fueled by some recent problematic and highly visible cases, this skepticism continues, despite the growing number of empirical assessments concluding that in the main privatization improves profitability and efficiency and increases returns to shareholders, particularly for firms in competitive or potentially competitive markets.

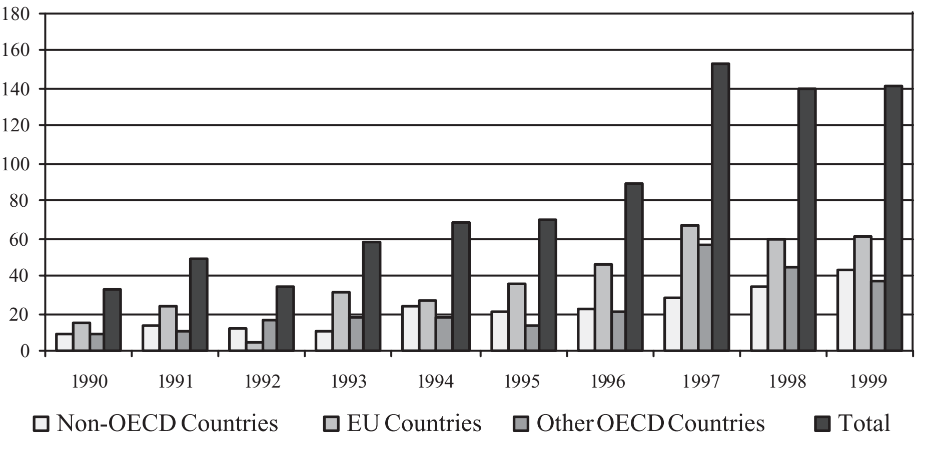
What are the strands of the antiprivatization argument? First, opponents contest that privatization has produced financial and operational benefits, or at least enough to offset the social dislocation it causes. Some who acknowledge performance improvements attribute them to increased competition rather than change of ownership, with the implication that less painful instruments could effect needed financial and efficiency gains. Second, there is fear that privatization leads to layoffs and a worsening in labor conditions, in the short term in the divested firms and in the longer run in the economy at large. Third, some argue that even if privatization enhances enterprise efficiency, the bulk of the benefits accrue to a privileged few—shareholders, managers, domestic or foreign investors, those connected to the political elite—whereas the costs are borne by the many, particularly taxpayers, consumers, and workers, thus reducing overall welfare. In addition, many are concerned that the often perceived corruption and lack of transparency in privatization transactions have minimized gains and increased broader problems of governance. Underlying all of these arguments is the fundamental concern that privatization has been applied without proper regard to a country's economic and social conditions, often at the behest of external actors.

This article takes stock of the empirical evidence on privatization outcomes and explores why privatization provokes such opposition. The first section summarizes privatization trends in the past 15 years. The second section reviews the literature on the impact of privatization at the enterprise and social welfare levels, taking into account the differences between competitive and infrastructure firms, and examines the employment and broader macroeconomic and fiscal impacts. The third section discusses the growing concerns with privatization, focusing on how to design and implement privatization reforms that achieve their underlying economic objectives.

Trends in Privatization

Privatization started slowly.[1] Through most of the 1980s, there were only a few divestiture transactions a year. The number of transactions peaked in the mid-1990s and then declined after 1997. Between 1990 and 1999, global proceeds totaled US$850 billion, growing from $30 billion in 1990 to $145 billion in 1999 (figure 1). Organisation for Economic Co-operation and Development (OECD) countries, alongwith Brazil, account for the overwhelming bulk of the proceeds, mainly from public offerings of large firms in countries of the European Union (Mahboobi 2000).

Figure 1. Global Privatization Proceeds 1990–99 (US$ billions)



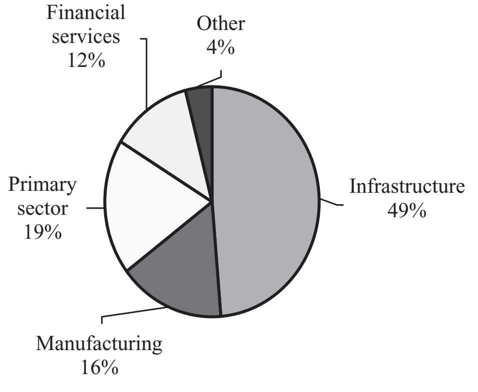
Source: Mahboobi (2000).

In non-OECD countries, privatization activity grew rapidly through the mid-1990s, with tens of thousands of enterprises sold and roughly $250 billion in revenues raised during 1990–99. Proceeds peaked at $66 billion in 1997 and then fell following the Asian and Russian financial crises and the ensuing general economic downturn. Revenues during 1990–99 were accounted for largely by infrastructure privatizations, mainly in the telecommunications and power industries, followed by petroleum, mining, agriculture, and forestry. Manufacturing sales accounted for about 16 percent of developing economy privatization proceeds, mainly from sales in Eastern and Central Europe and Latin America (figure 2). By the end of the 1990s, privatization revenues were concentrated in the oil and gas sectors in Argentina, Brazil, India, Poland, and Russia.

By region, Latin America and the Caribbean accounted for the largest share of privatization proceeds (figure 3), with the largest contributions coming from the sale of infrastructure and energy firms in Argentina, Mexico, and Brazil. Eastern Europe and Central Asia sold the largest number of firms, mainly through mass privatization voucher programs before 1995 in Russia, the Czech Republic, Slovakia, Kazakhstan, Lithuania, Ukraine, and Moldova. Sales proceeds were low under the giveaway voucher schemes, but revenues grew after 1995, as countries such as the Czech Republic, Estonia, Hungary, and Russia began or expanded case-by-case sales, including large firms in banking, transport, oil and gas, and infrastructure.

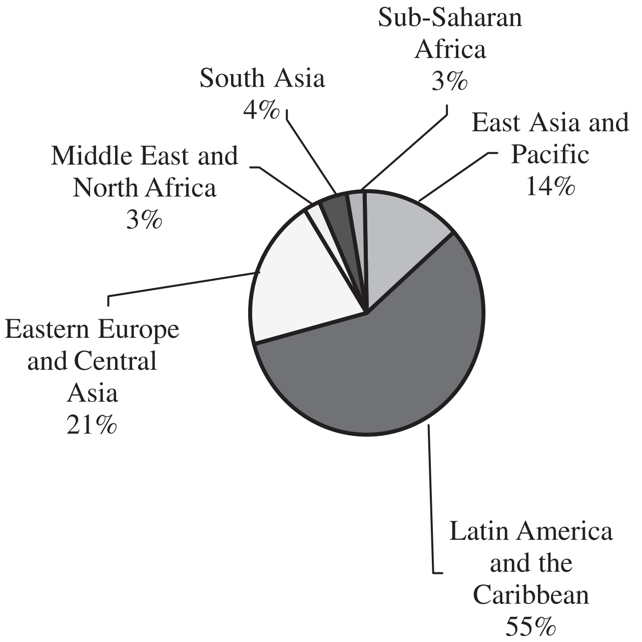
Before the financial crisis of 1997, East Asian countries generally concentrated on opening up their economies to new private entry rather than on privatizing enterprises. This approach was workable, given the region's smaller reliance on state enterprises as agents of economic policy (except in the People's Republic of China and a few other Asian socialist states), the success of China's evolutionary

Figure 2. Privatization Proceeds by Sector 1990–99 (US$ billions)



Source: World Bank (2001b).

Figure 3. Privatization Proceeds by Region, 1990–2000 (US$ billions)



Source: World Bank (2001b).

approach to property reform, and the relatively sound financial and fiscal position of most Asian states.

China stands out. Over a 25-year period, Chinese governments created or allowed forms of industrial ownership, particularly at the subnational level, that successfully combined elements of collective and private property. Later, new private entry and foreign direct investment were permitted and encouraged. By 1998, the nonstate sector (including private agriculture) accounted for 62 percent of GDP, whereas state enterprises' share in industrial output declined from 78 percent in 1978 to 28 percent in 1999 (Zhang 2001).

Since 1987, there have been numerous privatizations of small and medium-size collectively owned enterprises in China and further experimentation with ownership forms at the local level. Government has repeatedly announced its intent to clean up and formally privatize even large state enterprises. Many firms carved out their better assets to set up new companies for initial public offerings on the stock market and then became the largest controlling shareholder. There has thus been some dilution of shares over time but—until very recently—mostly to other state entities. Although less concentrated ownership has led to private takeovers in a few cases, full privatization continues to move slowly, mostly because of the social welfare responsibilities of state enterprises. But the need to face the burgeoning financial problems of the largest state enterprises has led to a renewed emphasis on privatization. Initial reviews indicate a positive impact on firm performance, with higher wages for workers but starkly lower overall employment (Jefferson and others 2003).

In Sub-Saharan Africa, sales rose from 175 in 1990 to more than 400 in 1996 and then jumped to more than 2,200 by 1998,[2] with sales concentrated in Mozambique, Angola, Ghana, Zambia, Kenya, Tanzania, and Guinea (Campbell White and Bhatia 1998; Nellis 2003). But the small size of most divested firms limited the financial impact: African sales accounted for 3 percent of total developing country proceeds during 1990–99. Estimated revenues over the decade for 37 Sub-Saharan states totaled $9 billion, less than the amount raised by sales in New Zealand alone (Nellis 2003) and about a third of the value of two Brazilian telecommunications auctions in the mid-1990s.

In the Middle East and North Africa, privatization revenues have been modest, below even those of Sub-Saharan Africa. Revenues grew in the late 1990s, largely as a result of Morocco's telecommunications sale and the privatization of cement and other large and medium-size companies in Egypt.

In South Asia, Sri Lanka has had an active privatization program covering virtually all sectors (including infrastructure), but India has accounted for the bulk of regional proceeds through sales of minority shares in large companies and the recent sale of controlling stakes in a few large firms.

Impact of Privatization

In many ways privatization in the early years was a leap of faith. Few dispute that state enterprise performance had not lived up to expectations and that reforms short of ownership change had had modest effects. Still, there was neither great theoretical justification nor hard evidence at the beginning of the 1980s that the performance problems of state enterprises could be altered by change in ownership. Thus, the bulk of privatizations before 1992–93 took place in the absence of empirical support.

Then, during the 1990s, the privatization assessment industry grew rapidly. Assessments analyzed types of impacts and differences between enterprises in competitive markets and those in monopoly sectors. Most of the 100-plus assessments now available cover competitive enterprises, focusing on performance and comparing productivity and profitability and changes in output, investments, and capacity utilization before and after sale. The studies conclude that privatization improves performance and increases returns to new owners and shareholders, with more robust findings in high- and middle-income countries than in low-income countries.

In infrastructure sectors, the more crucial issue is the broader welfare effects of privatization—the net addition to or subtraction from societal wealth produced by privatization, based on an assessment of the gains and losses to stakeholders. Given the daunting data and methodological demands of this approach, the few studies of the strict welfare type that have been done tend to cover middle-income or developed economies. They generally indicate that in the proper policy and regulatory settings, privatization substantially improves welfare compared with what would have happened had the enterprise remained under public ownership. As will be discussed, these findings are supported by more recent partial or limited welfare-type work, concentrated largely in Latin America.

There has been much concern about the employment and broader distributional impacts of privatization. Studies show large-scale job reductions in highly protected infrastructure sectors, though the number of workers dismissed as a result of divestiture is generally small relative to the total labor force. Analysts conclude that privatization is not a prime contributor to the large recent increases in general unemployment rates in developing economies. Wider income distribution issues are only beginning to receive analytical attention. Finally, the few available analyses of the fiscal and macroeconomic effects of privatization show fiscal benefits and a positive correlation between privatization and growth.

Enterprise Performance

Studies for a wide range of countries show that privatization improves enterprise performance. For firms in competitive markets (infrastructure firms are treated in the next section on welfare effects), profitability usually increases, often substantially, as do efficiency (measured by real sales per employee), output, and investment. These outcomes are seen in cross-cutting studies covering both developed and developing economies, as well as in case studies of developing and transition economies, but they are generally more robust for high- and middle-income countries than for low- or lower-middle-income countries.

Cross-cutting studies. Megginson and Netter (2001) survey cross-cutting studies that evaluate the impact of privatization on firm performance. The most comprehensive studies use a similar methodology to compare performance measures before and after privatization (over at least three-year periods) for large numbers of companies in developed and developing countries, privatized mainly through public share offerings (Megginson, Nash, and van Randeborgh 1994; Boubakri and Cosset 1998; D'Souza, Nash, and Megginson 2000). These studies find similar results. Weighted averages of the mean values show that profitability, defined as net income divided by sales, increases from an average of 8.6 percent before privatization to 12.6 percent afterward. Efficiency rises from an average of 96.9 percent in the year of privatization to 123.3 percent in the period after privatization. Between 79 and 86 percent of firms see increases in output per worker. Most firms achieve economically and statistically significant increases in output (real sales) after privatization and significant decreases in leverage. Capital investment spending increases slightly, whereas employment changes are ambiguous (see later discussion). Accounting for most of the performance improvements are changes in the incentive and management structure, along with improved corporate governance.

One concern is that such cross-cutting studies suffer from selection bias. Firms sold by public offering might be the cream of the crop, because to meet stock exchange listing requirements they will have to have been profitable for some time, possess up-to-date and accurate accounts, and in general be among the largest and best-performing firms privatized. That might mean that performance improves not because of privatization but because firms with the highest potential are privatized. Selection bias may be intensified by the overrepresentation of developed economies in the samples of early studies, because of data limitations. Comparing accounting information across countries and at different points in time is also risky. Most of the studies do not account for exogenous changes in the macroeconomic or business environment, which can influence the outcomes of privatization. Finally, there is concern that using profitability as an indicator of improved performance is flawed because the private sector is by definition profit maximizing, whereas profit is not as salient a goal in the public sector.

Some studies address these methodological drawbacks. Boubakri and Cossett (1998) analyze the performance of 79 newly privatized firms in 21 developing economies between 1980 and 1992. Their sample is well diversified, with wide geographical coverage, countries of different levels of development, and firms of different sizes and in different industries and market structures. They find significant increases in profitability (124 percent higher on average after privatization), operating efficiency (real sales per employee up 25 percent on average and net income per employee up by 63 percent), capital investment spending (up 126 percent), and employment (up 1.3 percent) and a decline in leverage. The changes in profitability and efficiency were larger in middle-income countries than in low-income countries. One study that looks at the incidence and importance of selection bias finds no evidence of it in a set of privatizations in Central Europe (Frydman and others 1997).

There is also the possibility that performance improvements would have happened without a change of ownership—if general economic conditions improved and boosted all firms, or if public sector managers and owners were able to put in place and sustain reform measures. Omran (2001) reviews indicators in privatized and remaining state-owned firms in Egypt in the 1990s and finds that all firms improved, regardless of ownership type or change. He concluded that general liberalization was more important than privatization in explaining firm behavior.[3] Few studies evaluate the counterfactual in any systematic way, however, the most notable being Galal and others (1994; discussed later).

Another issue is timing. Dewenter and Malatesta (1997) and Hodge (2000), although agreeing that ownership change produces positive effects, argue that many performance improvements occur well before privatization, while enterprises are still under state ownership. But these improvements are generally motivated by the "announcement" effects of divestiture. From Mexico to the United Kingdom, many long-avoided reforms were made in the run-up to privatization, including change of management, layoffs and other cost-cutting measures, and enhanced competition through changes in trade regime and pricing. The issue is whether these improvements could have been initiated and sustained had they not been precursors to divestiture. Proponents of privatization view it as necessary to "lock-in" the gains and prevent backsliding (World Bank 1995).

Developing country studies. In developing economies, most of the growing body of work assessing performance before and after privatization concludes that privatization improves enterprise performance. La Porta and López-de-Silanes (1997), in a study of 218 nonfinancial firms privatized in Mexico during 1983–91, conclude that state enterprises went from being highly unprofitable before privatization to being profitable thereafter, closing the performance gap with control groups of similar firms in the private sector. Output (inflation-adjusted) increased 54.3 percent, sales per employee roughly doubled, and profitability increased 24 percent. Controlling for changes in the macroeconomic environment, they find that improvements were due mainly to productivity gains resulting from better incentives and management associated with private ownership and partly to lower employment costs resulting from labor reductions.

In Brazil, privatization also improved the efficiency and profitability of state enterprises (Macedo 2000). During 1981–94, before privatization, the ratio of profits to net assets was negative, averaging −2.5 percent and falling to −5.4 percent toward the end. Significant gains were achieved after privatization. The large steel mill, which had been incurring heavy losses, became profitable, and investments increased dramatically. Higher profits brought more tax revenues to the government, and the company began paying dividends. Using a similar methodology to analyze the performance of 50 Brazilian state enterprises before and after privatization, Pinheiro (1996) concludes that privatization significantly improved performance, particularly when there was a change of control rather than a sale of only a minority stake. Results were stronger for companies that had been recently sold, indicating that privatization works better when combined with liberalization measures that remove barriers to entry and exit, result in positive interest rates, and reduce access to budget resources.

More—and more robust—success stories come from high- or middle-income countries than from low-income countries faced with difficult market conditions and wary investors. A study of 16 African firms (10 from North Africa) privatized through public share offering during 1989–96 finds a significant increase in capital spending by privatized firms—but only insignificant changes in profitability, efficiency, output, and leverage (Boubakri and Cossett 1999). Still, a number of privatized companies in Sub-Saharan Africa increased capacity utilization through new investments, introduced new technology, and expanded markets (Campbell White and Bhatia 1998). Several recent examinations of country privatization programs—in Ghana (Appiah-Kubi 2001), Mozambique (Andreasson 1998), and Tanzania (Due and Temu 2002; Temu and Due 1998)—report strong performance improvements in privatized manufacturing, industrial, and service firms.

Transition economies. Assessing privatization's impact in transition economies is more difficult. Concurrent sweeping economic and social changes compound the problem of separating privatization's effects from other factors. Information and analytical shortcomings are particularly acute, especially for economies that were formerly part of the Soviet Union. Djankov and Murrell (2002), in reviewing empirical studies of enterprise restructuring and ownership change, conclude that private ownership produces more restructuring than state ownership in most transition economies. But regional differences are acute: The privatization effect in Central and Eastern European countries is more than twice that in former Soviet countries. In the enormously important case of Russia, they find little if any difference in performance between privatized and state firms.

Different sales methods and the types of owners they produce seem to account for much of this variance in outcomes. The Central and Eastern European countries that privatized largely through trade sales on a case-by-case basis (Estonia, Hungary, Poland) ended up with concentrated strategic owners, often foreigners, who tend to be more productive than diffused domestic shareholders. Firms in former Soviet countries, which relied mainly on mass privatization through vouchers, tended to have less positive results. Mass privatizations led to insider ownership (by managers and employees) and widely diffused shareholding among small, first-time equity holders—as evidenced most acutely in Russia, where 70 percent of the 13,000 enterprises privatized by vouchers in 1992–94 became insider-owned.

The hope was that these inside owners, supported by newly formed investment funds, would soon open their firms to outsiders with money and expertise. But insiders proved reluctant to give up control, and outside investors were wary of the unsettled circumstances of early transition Russia. The upshot of this failure to concentrate ownership through the secondary market was, for a time, limited restructuring. Subsequent nontransparent cash sales of the larger enterprises—exemplified by the notorious loans-for-shares program—helped create kleptocracy, as many high-potential firms were transferred to a small group of investors at very low prices (Black, Kraakman, and Tarassova 2000). Although some prominent economists (most notably Stiglitz 1999) condemned the process, others concluded that privatization, unfair as it was, still led to performance improvements in Russia and other in transition economies, at least in firms where outsiders succeeded in securing control (Barberis and others 1996; Earle 1998; Earle and Estrin 1998; Aslund 2001). The argument is one of political economy: "Privatization in Russia worked considerably better than its politically feasible alternative: doing nothing" (Shleifer and Tresiman 2000:38).

Method of sale and concentration of ownership do not explain all the variation in performance. Another important part of the explanation is differences in levels of institutional development and in policy approaches to new entry and hard budget constraints (discussed further later). In transition economies everywhere, the best performers were new private entrants—firms that were never in state hands.

Welfare Effects

Privatized infrastructure firms also recorded performance improvements. A recent survey shows that the introduction of incentives helped reduce costs and improve revenue collection in infrastructure firms (Harris 2003). Although gains were most dramatic in the telecommunications sector, in large part because of increased competition, substantial improvements took place in less competitive sectors such as power and water as well. Losses in the Chilean electricity sector, for example, more than halved after privatization and similar gains took place under more difficult circumstances in Georgia and Namibia.

But for infrastructure sectors, with their monopoly or network characteristics, the ultimate test for assessing privatization's impact is not simply firm performance, as it is for competitive firms, but the difference in economic welfare relative to what would have happened had the enterprise remained state-owned. Better financial and operational performance at the firm level is part of the story, but a transaction can benefit a firm and its owners without benefiting other stakeholders and society at large.

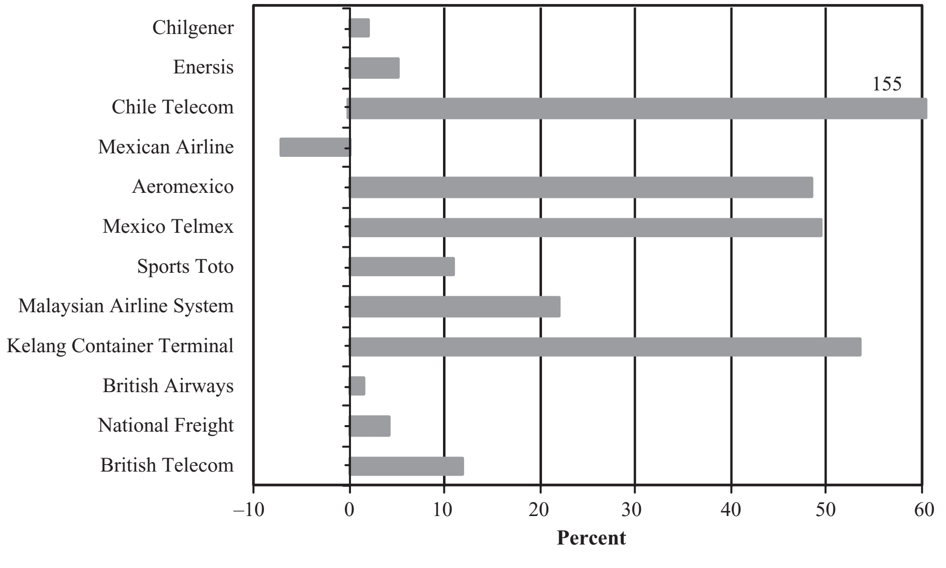
Selling an inefficient public sector monopoly to an unregulated private owner will almost certainly result in increased firm profitability and higher returns to the new shareholders and perhaps in higher salaries and expanded job opportunities for workers and greater returns to government. But these gains can easily be outweighed by the welfare losses imposed on consumers and the economy as a whole from inadequate access to products and services, their suboptimal supply, or their excessively high price.

Despite the recognized importance, only a few studies of the broader welfare effects have been undertaken. One problem is the heavy data demands. To estimate the counterfactual, analysts need detailed information on firm performance before and after the sale and equally detailed information on the policy climate, social outcomes, and myriad other factors. Even in the most data-rich settings, such as the United Kingdom, analysts readily admit that construction of the counterfactual, the "what if," is inevitably based on a more than normal amount of "crystal ball gazing" (Newbery and Pollitt 1997).

A seminal study by Galal and others (1994) estimates the welfare consequences of privatization in 12 (mostly) infrastructure enterprises in one developed and three middle-income countries, looking at the effects on enterprise efficiency, subsequent investment, and consumer welfare. Employing a modified form of cost-benefit analysis, the study examines the impact on all actors, compares performance before and after privatization, and contrasts performance after privatization with a hypothetical scenario of reformed state ownership, with new technology and more rational procedures. The conclusion: Divestiture substantially improved economic welfare in 11 of the 12 cases, mainly due to a dramatic increase in investment, improved productivity, more rational pricing policies, and increased competition and effective regulation (figure 4).

In a study of the welfare effects of privatization of the electricity sector in the United Kingdom, Newbery and Pollitt (1997) argue that efficiency improved significantly in the first years following privatization. But from their counterfactual analysis, they conclude that the new private shareholders captured the bulk of the financial gains at the expense of government and taxpayers. Consumers/taxpayers did reap some benefits: It was not a case of winners and losers, but of huge winners

Figure 4. Welfare Effects of Divesting 12 State Enterprises



Note: Welfare gains are presented as a percentage of annual sales in the last year before privatization.
Source: Galal and others (1994).

and very small winners. Domah and Pollitt (2000) look at the welfare consequences of privatizing regional electricity supply and distribution in England and Wales and estimate large welfare gains, first to the seller and then to consumers.

There has been just one application of the strict welfare methodology in low-income countries, Jones, Jammal, and Gokgur's (1998) study of 81 privatizations in Côte d'Ivoire. The analysis covers not just infrastructure firms but also a range of firms already operating in competitive markets (in agriculture, agro-industries, and tradable and nontradable sectors). For the entire privatized sector, they conclude that there were substantial benefits: Firms performed better after privatization than before, they performed better than they would have had they remained under public ownership, and the set of transactions as a whole contributed positively to economic welfare, with annual net welfare benefits equivalent to about 25 percent of predivestiture sales. These results stemmed from a number of effects, including increases in output, investment, labor productivity, and intermediate input productivity.

In recent years, several partial or limited welfare analyses of privatization have been conducted, most focusing on Latin America. One set of studies sponsored by the World Institute for Development Economics Research of the United Nations University developed less elaborate counterfactual constructions in an effort to measure the social effects of privatization of infrastructure and network industries.[4] The Bolivia study (Barja and Urquiola 2001) simply compares performance before and after privatization, looking for breaks in trend lines at the time of sale and for differences in the economic and political frameworks in the two periods, and estimates the possible effects on performance after privatization. In Peru, Tórero and Pascó-Font (2001) limit themselves to estimating the effects of infrastructure privatization on different income groups, using a rudimentary counterfactual that assumes no change of ownership and the continuation of preprivatization pricing policies. A similar study for Argentina (Delfino and Casarin 2001) finds varying social outcomes depending on which of three price elasticity of demand figures is used, that all three show increases in production, quality, and access following divestiture. Almost all the studies conclude that on the whole, consumer surplus expanded after privatization, even though in most cases prices also increased.

Another recent set of Latin American studies—covering Argentina, Bolivia, Mexico, and Nicaragua—examines the distributive impact of privatization. Based on the country studies, McKenzie and Mookherjee (2002) calculate the welfare impact on consumers from changes in price, access, and quality of service, taking into account changes for different expenditure groups. They find that in all cases privatization resulted in increased access to services, especially for poorer consumers, who had less access to begin with. Prices fell in half the cases and rose in half, though the positive distributional gains from access outweighed the impact of increased prices. Privatization was generally followed by an improvement in service quality. In almost no cases was there evidence that changes in price or access led to increased poverty.

Regarding access, Harris (2003) confirms a positive impact in such sectors as water and power in countries at various levels of development, as increased investment leads to expanded coverage and access and as sales contracts often require that much of the expansion benefit previously unfavored groups or regions. Clarke and Wallsten (2002) use household data from around the world to examine the performance of public utilities in meeting universal service obligations and the impacts of reform. They find that state monopolies everywhere except in Eastern Europe failed to provide service to poor and rural households and that privatization reforms did not harm poor and rural consumers and in many cases improved their access to utility services. Prices, as noted, often rise following privatization to offset prices that have long been well below cost. In many instances this has a negative distributional impact—but in addition to being outweighed by access, these effects can be muted by regulatory frameworks or subsidies aimed at protecting the less favored. Chile, for example, subsidized telephone costs in rural regions. (For a general discussion of mitigating measures, see Estache, Foster, and Wodon 2002; Clarke and Wallsten 2002; and Estache, Gomez-Lobo, and Leipziger 2000.)

The welfare studies conclude that privatization generally increases the resources available in the economy, including those available to governments. The studies also conclude that although few privatizations result in gains for all stakeholders (sellers, buyers, consumers, workers, and competitors), most produce gains for some and losses for others, depending on how the transaction is structured, the policy framework, and the institutional development and competence in the economy. Although the distribution of gains and losses varies in the studies, in almost no case do the new private owners come out on the losing side. The variance is larger for other stakeholders, including consumers, workers, and sellers. Even in cases of increased consumer surplus, the distribution of gains varies by income decile.

What is clear from the studies is that the aggregate gains are greatest when privatization is combined with proper competition policies and regulatory frameworks. The welfare effects have been shown to depend crucially on the fairness and capacity of the regulatory system. Chisari, Estache, and Romero (1999:376) conclude that "how serious governments are about the fair distribution of gains from privatization reform is revealed by how serious they are about regulation." (Regulatory issues are treated in greater detail later.)

Employment and Distributional Effects

State enterprises tend to be overstaffed. Consider these examples. In Sri Lanka in 1992, estimated redundancy in eight of the largest firms (in electricity, railways, shipping, sugar, cement, and petroleum) averaged 53 percent (Salih 2000). Prior to privatization, Argentine railways, with more than 90,000 employees, had a wage bill equivalent to 160 percent of the firm's total revenues (Ramamurti 1997). Such levels of overstaffing contributed to the financial weakness of state enterprises.

Excess labor is one of the first cost areas addressed by reforming governments or new private owners. A recent survey of 308 privatized firms shows worker reductions in close to 80 percent of firms after privatization (Chong and López-de-Silanes 2002). An earlier review of 17 privatizations found job increases in 4 (averaging 23 percent), no change in 6, and job losses in 7 (averaging a substantial 44 percent of the workforce before privatization), predominantly in tobacco, water supply, and electricity (Van der Hoeven and Sziracki 1997).

A number of highly protected and deeply politicized enterprises have seen huge declines in net employment, often before but also after privatization: 80 percent in Argentina's railways, 72 percent in petroleum, and 50 percent in electricity enterprises; 82 percent in Brazil's railroads; 42 percent in Manila water; and 50 percent in a study of Mexican firms. Moreover, although D'Souza and Megginson's (1999) study of 78 privatized firms in 25 countries finds insignificant employment declines for the group as a whole, reductions were substantial for a subgroup of noncompetitive firms. Much of this labor shedding was required to bring employment and labor costs in line with that in competitor or similar firms.

Some firms in competitive sectors, with relatively efficient staffing levels before privatization, and firms in high-demand sectors, such as telecommunications, experienced little decline in employment (Galal and others 1994; Megginson, Nash, and van Randenborgh 1994; Boubakri and Cosset 1998; Kikeri 1998). The general expectation is that downsizing will be temporary and that growth in restructured private firms will rebound. In some cases, this has happened. In a set of Eastern European countries, employment declined just before and during privatization, but subsequently increased (Estrin and Svejnar 1998). Jones, Jammal, and Gokgur (1998) confirm labor shedding before privatization in their study of Côte d'Ivoire. But they find that firms slated for privatization shed less than the economy as a whole, suggesting that layoffs were a response to weak economic conditions rather than to privatization itself. Indeed, they argue that privatization may have resulted in less labor shedding, possibly to minimize workers' opposition to privatization. Moreover, the privatized sector did significantly better than enterprises as a whole in terms of job generation.

Several studies report that employees who retain their jobs in privatized firms receive the same or higher wages than they did before. In Brazil, for example, employment reductions were sizable in large firms privatized in the 1990s (48 percent on average), but productivity improvements resulting from restructuring led to higher wages and performance-based incentives for workers who remained (Macedo 2000). Similar evidence is found in Argentina (Ramamurti 1997), Côte d'Ivoire

(Jones, Jammal, and Gokgur 1998), Malaysia (Galal and others 1994), and Mexico (La Porta and López-de-Silanes 1997).

There is a widespread public perception that privatization is the main cause of the large increases in unemployment in many regions in the last decade and thus a prime contributor to a number of social ills, including increased poverty and inequality. Recent research suggests a more nuanced picture. Privatization has contributed to general unemployment levels, but only slightly. It is rarely a principal or even important cause of rising unemployment, poverty, or inequality. The evidence comes mainly from Latin American studies that argue that while privatization has resulted in job losses, the aggregate numbers are small relative to the national workforce (Barja and Urquiola 2002; López-Calva and Rosellon 2002; Ennis and Pinto 2002; Freije and Rivas 2002, with findings summarized in McKenzie and Mookherjee 2002). They conclude that privatization is not a main cause of overall increases in unemployment and wage differentials, even where both have risen dramatically.

Other studies support this view. Data from Argentina suggest that privatization was not a major contributor to the rise in unemployment between 1993 and 1995 but that the interest rate shock from regional instability was (Chisari, Estache, Romero 1999). In the early 1990s in Hungary and Poland, despite the slow pace of privatization, official unemployment grew rapidly, reaching 14.1 percent in Hungary in 1993 and 16.7 percent in Poland in 1993–94 (Nellis 1999). Behrman, Birdsall, and Szekely (2000), in an econometric study of the impact of economic liberalization on wage differentials in Latin America, conclude that privatization was negatively correlated with the growing wage inequality in reforming Latin American economies. Rather, privatization was mitigating the "disequalizing effects" of liberalizing reforms in the financial sector, the tax regime, and capital markets.

Finally, what of the broader distributional effects? Despite innovations aimed at spreading equity holdings—such as voucher schemes in transition economies and "capitalization" in Bolivia—there is a widespread perception, even among observers sympathetic to privatization, that privatization has had negative effects on wealth distribution, with upper-income groups gaining far more in equity shares than lower-income groups, at least in the short run.

Birdsall and Nellis (2002) review the available studies and conclude that most privatization programs have, at least in the short run, worsened the distribution of assets (very likely) and incomes (likely). This is far more evident in transition economies than in Latin America, and less clear for utilities—where the poor have tended to benefit from greater access—than for banks and oil companies and other natural resource producers. In the best-studied cases from Latin America, the conclusion is that privatization has contributed little or nothing to the growing inequality in the region and that it either reduces poverty or has no effect (McKenzie and Mookherjee 2002).

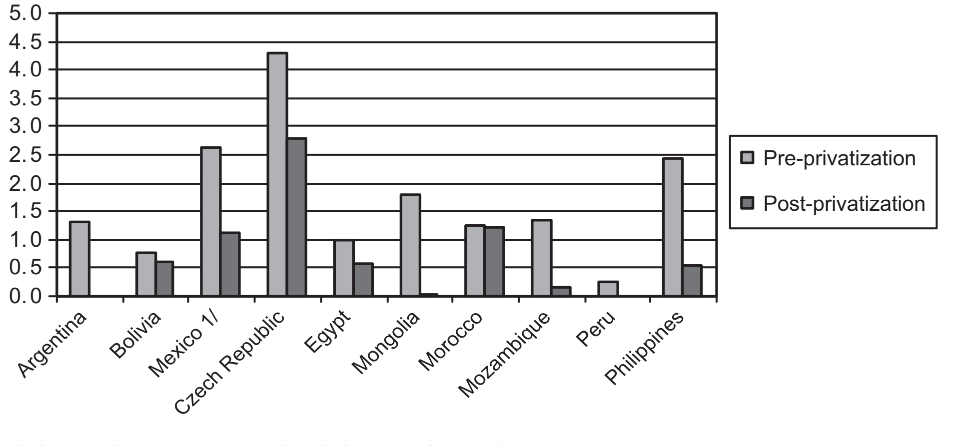
Macroeconomic and Fiscal Effects

The macroeconomic effects of privatization have been less studied than other aspects. One of the few such studies, by Davis and others (2000), calculates significant and positive benefits. Governments tended to be financially better off after privatization than before. Gross proceeds from privatization were substantial, amounting to 2 percent of GDP in a sample of 18 countries, and the fiscal situation of governments that saved rather than spent privatization proceeds improved over time.[5] Privatization produced other positive impacts on government revenue. Not surprisingly, government transfers to state enterprises declined substantially following privatization (figure 5), and broader indicators of consolidated state enterprise accounts for a number of countries indicated much smaller deficits.

The study also finds a positive correlation between privatization and overall rates of growth. The authors argue that although privatization is not the sole cause of subsequent increases in growth rates, it is a good proxy for the range of structural reform measures that contribute to the overall result. Investors and markets view privatization as an indicator of reform credibility, a less tangible but important macroeconomic effect.

Sheshinski and López-Calva (1998) also find that privatization improves the public sector's financial health. Budget deficits decline during the reform period. Low-income countries that are less aggressive privatizers have a larger deficit, on average. In high- and middle-income countries, privatization reduces net transfers

Figure 5. Gross Budgetary Transfers and Subsidies to State Enterprises for Selected Countries (Percent of GDP)



Excludes Petróleos Mexicanos and includes some decentralized government agencies.
Source: Davis and others (2000).

to state enterprises, and transfers become positive when the government starts collecting taxes from privatized firms—another contributor to positive macroeconomic effects. Despite concerns about the difficulties of tax collection, there is evidence of increased downstream revenues to governments through higher taxes in Africa (Campbell White and Bhatia 1988), Argentina (Shaikh and others 1996), Brazil (Macedo 2000), and Mexico (La Porta and López-de-Silanes 1997), among others.

On the use of net proceeds from privatization, the conventional wisdom is that the more they are devoted to retiring debt, the better. Debt reduction lowers interest rates, reduces further borrowing and inflation, and boosts overall growth. Four countries in the study by Davis and others (2000)—Argentina, Egypt, Hungary, and Mexico—had an initial stock of registered public debt ranging from 40 percent to 130 percent of GDP. Privatization proceeds contributed to a sharp decline in public debt between the year before the period of most active privatization and the last year of active privatization, helping strengthen and stabilize the economy. One problem is that there are strong claimants to the proceeds other than debt relief, and politicians often are obliged to balance the economic ideal with the politically feasible. Many governments (Argentina, Bolivia, Estonia, Hungary) have devoted a portion of privatization proceeds to covering pension costs (a form of debt retirement, because they are obligations of the state) or—a much more risky use—to the restructuring of some key state enterprises before or even instead of privatization (in Poland and the Czech Republic). Experience cautions against the use of proceeds to finance current expenditures, given the one-time nature of the proceeds and the risk that spending may become entrenched at unsustainable levels.

Emerging Issues

Despite the largely positive economic assessments, privatization is increasingly disliked—in general and in network industries in particular. Public opinion surveys from Western Europe, Latin America, South Asia, and Russia reveal that large and growing percentages of citizens view privatization as a harmful policy, often imposed by external agencies without due consideration for the economic and social context. Protests of higher prices, corrupt transactions, alienation of national assets to foreign investors, and job losses have become common—and in several cases, deadly—in Latin America, Sub-Saharan Africa, and India. Even in the United States, troubled partial privatizations (water in Atlanta) and flawed liberalization (associated in the public mind with privatization, such as electricity in California) have led many to oppose further reductions of state involvement, particularly in sectors such as water and power. Journalists in both developing and industrial countries often portray privatization in a negative light (see, for example, Finnegan 2002). Nongovernmental organization activists and analysts, supported by such noted economists as Joseph Stiglitz, question both the manner in which privatization has been implemented (without adequate regard for local conditions) and, at times, its essential rationale.

The causes of this discontent are several. First, when done badly, privatizations have simply gone wrong. In Russia and other economies in transition, hundreds of firms were more or less given away to a small group of agile or well-connected insiders. Many of the highest potential assets were sold at very low prices. Even when ordinary citizens obtained shares (in exchange for vouchers), this equity quickly lost most of its value. The bad outcomes may be few compared with the total number of privatization transactions,[6] but they are highly visible and have helped mobilize popular opposition—failed privatized toll roads in Mexico; troubled or canceled infrastructure concessions in Bolivia, Costa Rica, Hungary, India, Indonesia, Senegal, Ukraine, and half a dozen other countries; a privatized mine in Zambia that failed to obey the law on severance payments.

Second, and related, the process is political dynamite. The benefits of privatization tend to be diffused among consumers or citizens as a whole, small for each affected individual, and slow to materialize. To illustrate, a 10 percent reduction in electricity tariffs amounts to a large sum in the aggregate but might be of little significance to individual consumers. It normally takes some time before the other possible benefits of privatized electricity generation—less pollution, more reliable service that might stimulate private investment elsewhere in the economy—are discernible. The costs of privatization, however, are likely to be concentrated (dismissed workers, increased charges), large for each individual affected, and rapidly apparent. Politically, losses are felt more intensely than gains, with proreform consumers generally unorganized, silent, and nearly invisible politically, and antireform workers, civil servants, and antimarket intellectuals frequently organized and vocal. The political process naturally responds to the intense and those with "voice."

Third, privatization may have been oversold, particularly in countries with weak institutional capacity. Proponents underplayed the costs, predicted quick and widely shared gains, insisted on speed, and often claimed that ownership change was critical to a general economic turnaround. With the benefits overplayed, it is not surprising that privatization is blamed when general economic conditions fail to improve or when competitive markets and regulatory frameworks are not sufficiently developed to support privatization.

Going forward, what can be done to address these concerns? There is still much debate about ownership and competition that needs to be addressed. Equally important is improving the privatization process itself, taking measures to promote competition, putting in place proper regulatory frameworks, ensuring transparency, mitigating social costs, and tailoring privatization to local conditions.

Ownership or Competition?

Two decades of experience have not settled the debate over how much ownership matters. Neoclassical economic theory is somewhat agnostic on the effects of ownership. It regards market structure and the degree of competition to be of equal or greater importance. Empirically, some analysts conclude that increased exposure to competition accounts for most of the positive changes seen in privatized firms.[7] Indeed, some studies suggest strongly that competition has been more important than ownership change in bringing about efficiency gains.[8]

But the question remains: If enhanced competition and market restructuring are so efficacious on their own, why do the efficiency effects rarely occur or persist in the absence of ownership change? The poor experience with state enterprise reform in the 1980s and before shows the difficulties and limited results of reforms short of ownership change (see Shirley 1983; Nellis and Shirley 1991). Governments found it difficult to apply the full package of reforms needed (exposing state enterprises to competition, requiring them to access private capital markets for investment funds, creating a market for managers, isolating the process from political interference) and to leave the package in place long enough to change incentives and behaviors. Even where performance improved,[9] reforms did not endure, usually because of renewed political interference (World Bank 1995; Majumdar 1998; Shirley and Xu 2000). Governments almost never allowed insolvent state enterprises to fail and go out of business. Soft budgets continued, and in the absence of exit options, there was little pressure on government officials, managers, and workers to reform.

The difficulty of reforming state enterprises without privatization and the generally improved performance after privatization support the importance of ownership but do not conclusively prove it. Those who look at the issue statistically rather than causally argue that ownership change is associated with effective and enduring competition. For example, Shirley and Walsh (2000) sum up the ownership or reform debate based on a review of some 50 empirical studies covering a variety of countries and sectors. They find greater ambiguity about ownership in the theoretical literature than in the empirical literature. The clear majority of empirical studies concluded that privatized—and private—firms perform better than state enterprises, a finding that is robust across sectors and market structures and across developed and developing countries. Although a few studies find better performance by state enterprises in infrastructure sectors in developed economies, no studies find better performance by state enterprise in any sector or market situation in developing economies. Shirley and Walsh find that private firms do better in fully competitive markets. This advantage persists but is less pronounced in monopolistic markets, and the evidence is less conclusive.

The issue is less one of privatization versus competition. Rather, privatization and procompetition policies appear to be mutually reinforcing. Sachs, Zinnes, and Eilat

(2000) examine the empirical evidence across 24 transition economies and conclude that ownership change is not enough to generate improvements in economic performance. But when ownership change is combined with institutional reforms—aimed at removing barriers to entry and exit, improving prudential regulation and corporate governance, hardening budget constraints, and developing capital markets—progress is much greater. Maximum impact is achieved when market competitiveness, hardened budget constraints, and improved regulatory frameworks coincide with privatization. The higher the level of institutional reforms, the more positive the economic performance impact from a change of ownership. But institutional reforms do not guarantee performance improvements unless there is a minimum level of ownership change: The key finding is that economies must have private ownership and procompetition policies to progress. So, again: Ownership matters, but policies and institutions matter just as much.

Promoting Competition

Privatized firms perform better than state enterprises, but new private firms perform better than both. Promoting competition by removing entry and exit barriers and by linking privatization with financial sector reforms is crucial for the development of a dynamic and competitive private sector and thus for successful privatization.

Entry and exit. Particularly in infrastructure firms, economic benefits are maximized when privatization is combined with new entry, the break-up of large entities, price deregulation, and the development of effective regulatory frameworks—with the last being critical for equity as well as efficiency. Competitive markets and good regulation reinforce the benefits of private ownership. Divesting into competitive markets may reduce the revenues from sale, but efficiency, not revenues, should be the primary objective of privatization. A recent report (World Bank 2004) shows that earlier privatizations that granted long exclusivity periods to investors increased the sales price but led to problems as exclusivity reduced competition and thereby incentives for investment. In telecommunications, for instance, exclusivity reduced network expansion by 10–40 percent and the annual growth rate of the network by more than 2 percent. As countries have learned from experiences, exclusivity periods have grown shorter and some privatizations have taken place without any exclusivity.

Competition is equally important in tradable sectors. It requires eliminating import restrictions, deregulating prices, and simplifying procedures for starting a business. Removing entry barriers is particularly important in transition economies, where state enterprises dominated all markets and where restrictions on private participation and entry were powerful. For example, privatization of large state enterprises in Poland initially proceeded slowly, though most small firms were sold off quickly. Entry was permitted and vigorously encouraged, and harder budgets were at least temporarily imposed on most state enterprises that remained. Competition increased in all sectors of the economy, and asset stripping was minimized. However, the long and increasingly expensive delay in dealing with some large, overstaffed, loss-making firms, which are still in state hands, is a major contributor to Poland's recent economic difficulties. China's success is also in good part due to opening entry to domestic quasi-private enterprises and to foreign investment. In changing the public-private mix, privatization was for a long time less important than the emergence of new private businesses, although here, too, privatization of the larger firms is gaining ground and made easier by the presence of a competitive private sector.

Ultimately, competition means freedom to fail. Closure signals mismanagement, so governments have seldom allowed even obviously nonviable firms to go under. Privatization facilitates the liquidation or exit of nonviable firms. When purchasers have incorrectly estimated the market or their ability to restructure firms, closures have resulted; private owners have been able to do what public owners could not. Critics point to high liquidation rates after privatization (in places as different as Armenia and Guinea) as evidence that privatization is a failure. But closures do not necessarily indicate that privatization was misguided. Had these firms remained in state hands, they would likely have continued to receive subsidies, using scarce resources with high opportunity costs. Given the political difficulties associated with shutting down state enterprises, privatization may allow the liberation and transfer of assets from problematic management in the public sector to better management and more productive use in the private sector.

Linkages to financial sector reforms. Competition is engendered by the quality, pace, and scope of financial sector reforms, which in turn affect privatization outcomes. For example, the poor performance of privatized firms in many transition countries, including the Czech Republic, Slovakia, and Russia, resulted partly because insiders obtained control of the assets, but also because of the absence of financial sector reforms that would have forced even bad managers to take the right steps—or leave the way clear for other owners.

In the Czech Republic, the state continued to dominate commercial banking throughout the 1990s, maintaining essentially a controlling interest. Pressure from government allowed weak firms to borrow to stay in business. Little of the credit was applied to restructuring and much of the debt was nonperforming, with a fair percentage of it stolen (Cull, Matesova, and Shirley 2001). This severely weakened commercial banks and resulted in an enormous bailout. The Czech economy has largely recovered, but at a great cost. By contrast, Estonia and Hungary had less problematic privatizations because they implemented their bank restructuring and privatization programs early; dealt rapidly with the bad debt problems; tackled difficult legal and institutional reforms, such as bankruptcy and protection of minority shareholders; and partly as a consequence, received more inflows of foreign direct investment in the 1990s than their regional competitors. These factors, added to sales methods favoring concentrated ownership, produced more positive privatization outcomes.

A World Bank (2001a) report on finance and growth finds that the lower the income of a country, the higher the proportion of its bank assets that are state-owned. The theory was that state-owned banks would distribute capital to more productive investments, provide greater access to credit for deserving sections of society, and be less prone to crises. In practice, it has proven difficult to design incentives to guide either pubic or private banks toward efficient resource allocation. With state-owned banks, incentives are often especially weak, for political and other reasons, and the results are usually worse. State-owned banks have incurred some of the largest losses of recent times. State ownership tends to reduce competition through higher spreads on interest rates, leads to less stock exchange activity and nonbank credit, and results in greater concentration of credit, usually to the largest 20 firms, often inefficient state enterprises.

Privatization of banks is thus part of the solution. But experience in Argentina, Chile, and Mexico, among others, shows that bank privatization is a special case, more akin to infrastructure transactions than to privatizations in competitive sectors. As in infrastructure, good policy, monitoring, and enforcement are key. In weak regulatory environments, poorly designed and implemented bank privatizations have provoked major financial crises (Chile in the late 1970s, Mexico in the early 1990s). Although these rapid, insufficiently thought-out privatizations were mistakes, extended state ownership or control can have an equally detrimental impact, as the Czech case illustrates. Just as hasty privatization in weak environments can lead to problems, so can excessive delays, which undermine real sector reforms and impose high costs. Bank privatization remains the preferred strategy, but it requires caution and far more preparation than privatizations of ordinary commercial firms. Experience shows the need to sequence the phasing out of state ownership with the opening up of entry for private banks and improvements in the regulatory environment (World Bank 2001a).

Regulation

Successful privatization of natural monopolies requires development of regulatory frameworks and institutions that are independent, accountable, and resistant to capture by the private provider or the state. Such frameworks are essential to protect consumers against abuses of monopoly power, assure investors that they will be fairly treated, and address broader equity concerns.

Alexander and Estache (1999) find that Latin American countries, such as Chile, that devised regulatory frameworks up front and developed reasonable capacity to implement and enforce regulations had better success with privatization. Guasch, Laffont, and Straub (2003) also find that having well-defined regulations and a regulatory agency at the time of privatization lessens the need for subsequent renegotiations of contracts. The regulatory framework reduces the scope for error and the need for subsequent modifications that are time-consuming, disruptive, and signal wavering commitment. Wallsten (2002), in one of the few empirical studies on sequencing regulation and privatization, finds that establishing a regulatory authority before privatization of the telecommunications sector in Latin America and Africa was correlated with increased telephone penetration, investment, and mobile cellular subscriptions. Attention to the regulatory framework before privatization also increases the price investors are willing to pay for the firm.

There is widespread acceptance of the key elements of a good regulatory framework, including the need for coherent policies, transparency and public disclosure, predictability in the rules of the game, a proper balance between autonomy and accountability, and adequate institutional capacity. During the 1990s, developing economies created some 200 regulatory agencies with these elements in mind as part of infrastructure restructuring (Estache and others 2003). How have these regulatory frameworks and agencies worked in practice?

A recent assessment concludes that experience has been mixed (World Bank 2004). The report acknowledges progress in establishing independent regulatory agencies and notes that some agencies work well. But it argues that the technical and political complexities, with often conflicting objectives and tradeoffs, have made regulation one of the most challenging aspects of privatization. Political interference occurred at many levels—most critically in the sensitive area of service charges, but also in funding, the appointment of civil servants to regulatory boards, and the staffing of regulatory agencies. These factors weakened the independence and effectiveness of regulatory agencies, which in extreme cases became mere extensions of their ministries.

Lack of transparency is another problem. Citing surveys of regulators in sectors such as telecommunications and power, the report suggests that some agencies have no statutory obligation to explain their decisions, and some that do still fail to open meetings to the public. Also contributing to poor regulatory performance are inadequate data collection processes and the absence of quantitative models to estimate the impact of regulatory decisions on key financial and economic indicators affecting operators, consumers, and the government (Estache and others 2003).

Regulation has proven particularly difficult in low-income countries with weak overall institutional capacity. Governments in these countries have found it particularly difficult to regulate powerful economic actors fairly and effectively, to the detriment of privatization efforts. Among the problems they face are inexperience dealing with complex technical, legal, and financial issues; few if any precedents to build on; little or no reliable information on cost and performance; no watchdog groups; and no experience with independent agencies (Smith 2000).

Repeated efforts by governments and donors to build regulatory capacity, particularly in very poor countries, have produced few successes (urban water supply in Côte d'Ivoire is one). One reason is the attempt to transfer models and approaches from developed economies into developing economies without taking into account their differing political, legal, and institutional circumstances. Another is that changing ownership takes much less time than developing regulatory capacity, and the lower the income level, the slower the developmental process. Newbery (2001) points out that it took regulators in the United Kingdom five years to distribute to consumers some of the substantial efficiency gains produced by privatization of the electricity industry. Quick results should not be expected in developing economies, particularly in low-income countries.

The strongest lesson of experience is that there is no universal model: Regulatory frameworks need to take into account each country's unique political, legal, and institutional context (World Bank 2004). Better design and sustainability of regulatory frameworks are equally important. Alexander and Estache (1999) note that this generally involves creating clear and reasonable incentives; establishing competition, which drives incentives for efficiency and simplifies regulation; addressing the details of regulation (average changes, quality levels and penalties for not meeting them, interconnection rules) early in the process; and putting in place clear rules to ensure that all information is available in a timely and consistent manner. Estache and others (2003) highlight two additional steps to improve regulatory performance. One is to develop quantitative models that take into account the initial condition of the service, the objectives, and the regulatory instruments, thus allowing regulators to analyze sensitivities and simulate scenarios while minimizing subjectivity. The second is to do a better job of educating the general public, particularly on the tradeoffs between efficiency and fairness of service charges, which are the most acute and politically visible issues.

Transparency

Along with fears of increased unemployment and concerns about selling national assets to foreigners, a leading political concern in privatization is fear of nontransparent and corrupt transactions. Lack of transparency leads to allegations—and documented cases—of corruption, provides ammunition to opponents, creates backlash from investors and the public at large, and threatens to halt or even reverse privatization and liberalizing reform in general. In Latin America and elsewhere, surveys documenting the continuing decline of support for privatization reveal deep dissatisfaction with the perceived incidence and severity of corruption (Lora and Panizza 2002).

Strengthening transparency requires a host of measures. Especially important is ensuring that transactions occur without special privileges for insiders or other favored purchasers. Among other measures, that requires adhering strictly to standard, well-publicized procedures; vetting actions by the press or other outsiders (such as Transparency International); opening bids on TV or in public sessions; and publicizing the terms of the transaction or the privatization contracts. Promoting competition in the privatization transaction—from the selection of advisers to the selection of the final buyer—may be the most effective way to support transparency—and it also yields the maximum economic and financial benefits.

Although in some cases negotiated sales may be the only option, in general the greater the openness and competition in the selection process, the greater the number of bidders, the higher the price paid—and the higher the level of public acceptance and satisfaction. In Mexico, La Porta and López-de-Silanes (1997) found that an additional bidder participating in a tender increases the net revenues to government by 12 percent. Public offerings are widely regarded as the most transparent sales method, but most developing economies do not possess the capital markets, quality firms, or business environments required to apply this method.

Although enhancing transparency takes time, delays in privatization entail costs. Evidence from Bulgaria, Mexico, South Africa, and elsewhere indicates that once a firm is slated for privatization, delays in completing the transaction lead to declining operations, asset stripping, and lower sales price. La Porta and López-de-Silanes (1997) found in Mexico that net revenues to the government dropped 24 percent for each year that privatization was delayed. Ultimately, few bidders may come forth to buy the diminished assets, creating pressure on government to make special and costly concessions. But selling firms, particularly infrastructure firms, without first enhancing competition and regulation, and thus transparency, has proven even more costly. The general rule should be to move swiftly in privatizing firms operating in competitive or potentially competitive markets, but to take the time to get the market and regulatory structures right when privatizing infrastructure firms or banks.

Social Safety Nets

The extensive labor force reductions that usually accompany the restructuring of large state enterprises often lead to political backlash. One way to reduce tensions is to engage in dialogue with employees early on and to jointly work out acceptable solutions. Generally, this involves compensation payments, free or low-priced shares in the privatized firm, and augmented retirement and severance benefits to encourage voluntary departures in place of layoffs. Voluntary departures are often considered more politically and socially acceptable, and the financial and economic returns can be high. But such programs can be quite costly in the short run and can result in adverse selection (the best, most mobile workers apply to leave) and, in the case of early retirement payments, heavy financial burdens on the social security system

(Kikeri 1998; Rama 1999). For these reasons, Chong and López-de-Silanes (2002) argue that the optimal economic approach for governments to follow in any labor restructuring is simply not to intervene.

Compensation packages have often been combined with retraining to help workers reintegrate into the labor market. Although retraining programs are popular with governments and donors alike, the few available evaluations question their cost effectiveness (Dar and Tzannatos 1999). Targeting training to those who request it and who possess characteristics that increase the likelihood of putting the training to use improves the chance of success. Counseling and job search assistance have been found to be more cost effective than training (Dar and Tzannatos 1999). Contracting or outsourcing arrangements are another option. In Argentina, 5,000 surplus workers in the privatized oil company started 200 private businesses contracting with the oil company (Kikeri 1998). This approach has been tried in a number of other countries and sectors as well.

Concluding Comments

Mounting empirical evidence of privatization's benefits coincides with increasing dissatisfaction and opposition among citizens and policymakers. This dissatisfaction reflects the growing questioning of the benefits of privatization, particularly of large infrastructure and network industries, among large segments of affected populations. It reflects the general downturn of global markets in the past few years—and the collapse of several iconic firms—and the resulting swing of the economic pendulum back toward stability and accountability, and thus increased governmental supervision. It reflects the overselling of privatization as a panacea for all of a country's economic problems. It reflects the concern that privatization does not produce macroeconomic and distributional gains equivalent to its microeconomic benefits and that the transactions will be handled corruptly, with the proceeds lost or stolen.

On the other side of the ledger, we know that ownership change in productive firms, as well as private involvement in a less than full ownership capacity, usually improves the financial situation of the firm and the fiscal position of the selling government, increases returns to shareholders, and in the right policy circumstances, generates significant welfare benefits as well. These are major achievements. But they have not been able to offset the negative views of privatization, the fears that it creates or adds to injustice, inequity, and instability.

The evidence suggests that renewed efforts to reform state enterprises by methods short of ownership change or private involvement will not prove effective. The costs of no or slow privatization can be high. Thus, despite the problems, privatization should be neither abandoned nor reversed. Rather, there should be a strengthening and redoubling of efforts to privatize correctly. This means more advance analyses and better tailoring of privatization to local conditions. In countries with weak capacities, it also means emphasizing the policy and institutional underpinnings of market operations rather than focusing solely on privatization transactions. This involves developing and protecting competitive forces, creating proper regulatory frameworks (essential for both efficiency and equity) before privatization, introducing and enforcing transparency in sales processes, developing social safety nets for the adversely affected, and introducing innovative pricing and subsidy mechanisms to ensure that the poor have access to affordable essential services.

Notes

Sunita Kikeri is advisor in the Investment Climate Department at the World Bank; her e-mail address is skikeri@worldbank.org. John Nellis is senior fellow at the Center for Global Development, Washington, D.C.; his e-mail address is john.nellis@verizon.net. The authors would like to thank Michael Klein and Neil Roger for their comments on an earlier draft on which this article is based. Anonymous reviewers provided valuable comments.

1. This section uses data on global privatization proceeds from the World Bank's *Global Development Finance 2001* (World Bank 2001b). Data on privatization revenues must be viewed cautiously because they can be concentrated in a few large public offerings and thus do not reflect the scope or progress of a country's overall program.

2. Those numbers include small retail units and sales of minority shares.

3. However, previous liberalization reforms that did not include privatization had accomplished little in Egypt. It could be argued that only when privatization was a realistic option and credible threat did the remaining state enterprise managers take seriously the calls for reform.

4. The project, titled "Impact of Infrastructure Reforms in Latin America," produced papers on Argentina, Bolvia, Chile, Peru, and Spain and on various aspects of measurement and assessment of the social impact of utility privatization.

5. Most of the countries covered in the study had an International Monetary Fund program in place, with limitations on the deficit that may have influenced this finding.

6. Less than 2 percent of infrastructure concessions have been canceled (Harris and others 2003).

7. Tandon (1995) argues that there are many cases where privatization appears to have "resulted" in efficiency improvement, but that in most of the cases privatization was contemporaneous with deregulation or other types of competition-enhancing measures.

8. In reviewing the liberalization and privatization of the British electricity sector, Newberry and Pollitt (1997) argue that competition rather than privatization improved performance. They show that the efficiency gains were considerably less in the parts of the sector that were privatized but not liberalized than in other parts..

9. China is a rare case of evolutionary success, and even in China the problem of poorly performing core state enterprises has been postponed, not resolved.

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