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PRIVATIZATION

Over the past two decades, the privatization of state enterprises has gone from novelty act to global orthodoxy. More than 100 governments have sold stakes in state companies to private investors, raising $1 trillion and transforming the state's economic role. Though privatization's promise may have been oversold, its ills have also been exaggerated. The real question is how—not whether—to transfer state firms to private hands.

by William Megginson

Privatization Is Primarily an Economic Issue

Yes, but it is much more. The development of a large-scale privatization program is also a highly political act. Almost by definition, privatization represents an ideological and symbolic break with a history of state control over a country's productive assets. Nowhere is this symbolism more apparent than in the economies of Eastern Europe and the former Soviet Union, where privatization of state-owned enterprises (SOEs) has come to signal a nation's transition from communism to democratic capitalism. In Russia, the privatization of enormous petroleum (Lukoil), natural gas (Gazprom), and telecommunications (Syazinvest) companies represented a fundamental break from socialist state ownership. Even in Western Europe, Latin America, and other regions where SOEs traditionally have represented a smaller proportion of the economy, the sale of "strategic" assets such as national airlines or oil companies

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inevitably stirs strong political emotions, especially when foreign investors are among the buyers. The constitutions of both Mexico and Venezuela, for example, explicitly prohibit the privatization of their respective national oil monopolies, even to domestic capitalists.

The transfer of SOEs to the private sector reorients their basic purpose away from the political goal of providing employment and toward the economic objective of maximizing profits and wealth for shareholders. This transformation affects every aspect of a nation's business life. The companies usually slated for sale—telecommunications firms, banks, electric utilities, or airlines—tend to be the largest and most important in any given country. Any changes in the price and provision of their goods and services will have profound and daily effects on corporations and ordinary citizens. This shift from public to private ownership can also prompt stark changes in compensation and labor policies within privatized companies, shifting power away from labor and in favor of management and often undermining the national standing of public sector labor unions.

Privatization Occurs Mainly in Developing and Transition Economies

Not at all. The first major postwar "denationalization" program (as privatization was originally known) took place in Germany in the early 1960s, when Chancellor Konrad Adenauer's government sold part of its stakes in Volkswagen and the industrial company VEBA to private investors. However, the Thatcher government in Great Britain deserves most of the credit (or blame) for implementing the first modern privatizations. Then Prime Minister Margaret Thatcher pushed through the sales of British Aerospace and Cable & Wireless in 1981 in the face of intense Labour Party opposition, and even christened "privatization" with its more user-friendly name. Finally, the immensely successful sale of British Telecom in 1984 raised approximately $4.8 billion and entrenched privatization as a viable economic program; it convinced governments and investors around the world that virtually any size share offering could be sold on international markets, provided it was priced and marketed correctly.

Privatization truly went global only in the mid-1980s, as dozens of governments in Western Europe, South and East Asia, Latin America, and sub-Saharan Africa adopted comprehensive divestiture programs.

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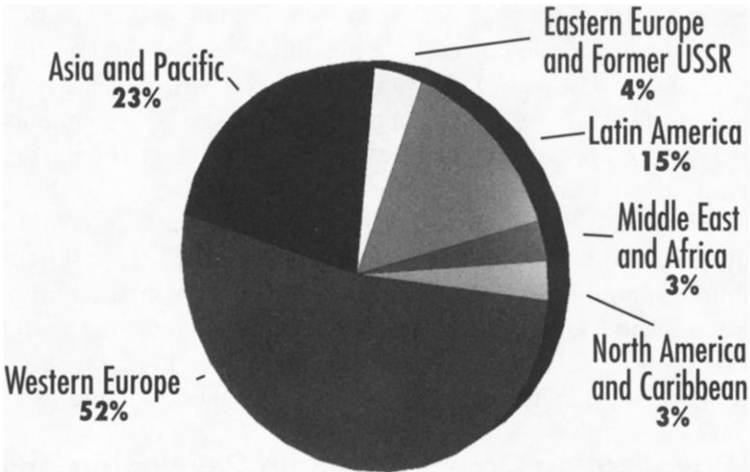
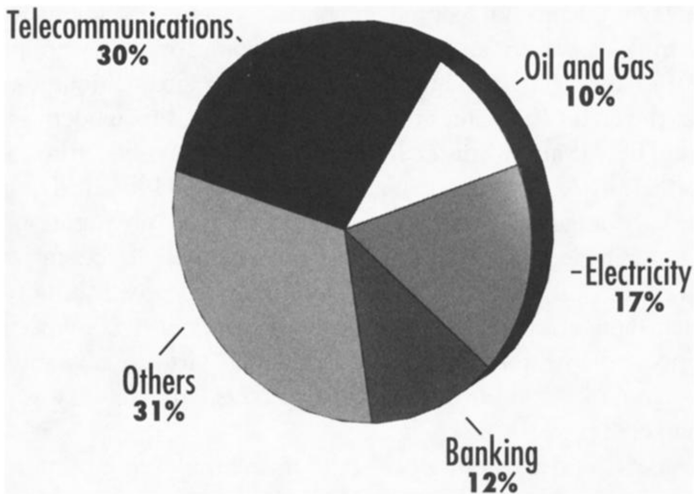
Everything Must Go!

Privatization Revenues by Region, 1988-98



Privatization Revenues by Sector, 1988-98



Source: Henry Gibbon's "Worldwide Economic Orthodoxy" (*Privatisation International*, December 1998).

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Latin America alone accounted for about one fourth of the value of worldwide privatizations from 1988 to 1993, during the heyday of the region's market liberalization and economic reform efforts. Japan also pursued privatization: The first three Nippon Telegraph and Telephone (NTT) offerings raised nearly $80 billion for the Japanese government, with the second NTT offering alone hauling in $40 billion. And after the collapse of European communism, Central and East European economies also embraced privatization, albeit with varying degrees of enthusiasm.

Global privatization revenue surged during the 1990s and peaked at more than $160 billion in 1997, before falling back to today's roughly $140 billion annual pace. However, most of the proceeds still come from Western Europe, with developing countries accounting for about one third of the annual funds raised via privatization. Cumulative revenues probably topped $1 trillion during 1999, and there is little reason to expect a sharp drop-off in activity any time soon. If anything, divestments should accelerate as privatization becomes more accepted as a policy and as more countries master the sales process.

Governments Sell State Enterprises to Make Money

You would think so, wouldn't you? In truth, raising revenue is but one of several objectives of privatization. Governments pursue privatization in order to promote increased efficiency, introduce competition, expose SOEs to market discipline, encourage foreign investment, foster wider share ownership . . . and raise revenue for the state. When privatization has formed part of a larger set of economic reforms that include fiscal austerity measures, some governments have opted for the fastest possible divestitures, even if doing so meant selling firms at fire-sale prices or if regulatory and market supports for such a transformation were inadequate.

Governments typically seek the highest possible price when they sell SOEs directly to a private company or to a consortium of investors. However, the objectives and motivations behind share issue privatizations (SIPs), in which the state sells ownership shares to the public, are more nuanced [see box on page 18]. In fact, governments often deliberately set share prices below expected market prices so citizen shareholders can reap short-term capital gains if they so desire. For example, the offer price for Deutsche Telekom's initial public offering (IPO) in November 1996 was

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Taking Stock

While governments tend to privatize small companies through direct sales to private firms or corporate investors, they often divest their largest enterprises through public stock offerings, also known as share issue privatizations (SIPs). These transactions are enormous and can dwarf even sizable corporate stock offerings. The 23 top share offerings in history have been SIPs, each far exceeding the largest U.S. stock offering ever: the $5.5 billion initial public offering by the United Parcel Service in 1999. The 20 largest SIPs are the following:

Date	Company	Country	Amount ($mil)
Nov 87	Nippon Telegraph & Telephone	Japan	40,260
Oct 88	Nippon Telegraph & Telephone	Japan	22,400
Nov 99	ENEL	Italy	18,100
Oct 98	NTT DoCoMo	Japan	18,000
Oct 97	Telecom Italia	Italy	15,500
Feb 87	Nippon Telegraph & Telephone	Japan	15,097
Nov 99	Nippon Telegraph & Telephone	Japan	15,000
Nov 96	Deutsche Telekom	Germany	13,300
Oct 87	British Petroleum	United Kingdom	12,430
Nov 97	Telstra	Australia	10,530
Nov 98	France Telecom	France	10,500
Oct 99	Telstra	Australia	10,400
Jun 99	Deutsche Telekom	Germany	10,200
Dec 90	Regional Electricity Companies[a]	United Kingdom	9,995
Dec 91	British Telecom	United Kingdom	9,927
Dec 89	U.K. Water Authorities[a]	United Kingdom	8,679
Dec 86	British Gas	United Kingdom	8,012
Jun 98	Endesa	Spain	8,000
Jul 97	ENI	Italy	7,800
Jul 93	British Telecom	U.K.	7,360

Notes: "a" indicates a group offering of multiple companies that trade separately after the initial public offering. Offers are reported in nominal amounts (not inflation-adjusted) and are translated into millions of U.S. dollars ($mil) using the contemporaneous exchange rate. Amounts reported for SIP offers are as described in the *Financial Times* at the time of the issue.

–W.M.

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well below the first-day trading price, thus yielding purchasers an initial return of 19 percent and enticing nearly 2 million German investors to become shareholders. And workers from divested companies are often eligible for generous discounts on shares—a not-so-veiled attempt to buy their acquiescence for the privatization of individual companies. The Argentine government did this as part of its initial offering of shares in the oil giant YPF by allocating 10 percent of the IPO to the firm's employees. Additionally, governments often restrict the participation of foreign investors in SIPs, though they rarely preclude it entirely. In short, policy makers seem intent on using SIPs to promote political support for economic reform programs—including additional privatizations.

Perhaps the clearest example of governments sacrificing sales revenue to achieve overarching political objectives is the widespread adoption of voucher privatization programs in the former Soviet bloc countries. Rather than sell SOEs for cash to private—usually foreign—investors, in some instances governments literally gave their shares away to citizens by distributing vouchers (free or for a nominal price) to the entire adult population. The vouchers could then be exchanged for ownership in companies being privatized. Voucher programs in the Czech Republic and Russia were especially visible and important, since they transferred so much of each economy to private ownership so quickly. Though politically popular initially, almost all of these programs have turned out to be economic disappointments. They have done little to engineer the necessary restructuring of SOEs, bring in new capital investment, or produce owners who demand that firms be operated efficiently. A comparison of banking privatizations in Hungary and the Czech Republic offers an especially potent lesson. Whereas Hungary allowed foreign investors to purchase large—often controlling—stakes in banks being divested, the Czech government resisted this for nationalistic reasons and also retained effective state control of the "privatized" banks. Six years later, banking in Hungary is vibrant, but the financial sector in the Czech Republic has become an even greater wasteland than it was under socialism.

Privatization Helps Governments Balance Their Books

Absolutely. Privatization has been a fiscal boon in two ways. First, most of the money raised has flowed directly to the divesting governments—not to the firms being privatized—so governments have raised almost $1 trillion without raising taxes or cutting benefits. For example, when a group

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of investors led by Telefónica of Spain purchased a controlling interest in Peru's telecommunications company Entel/CPT for $2 billion in 1994, the government received approximately $1.4 billion, with the buyers making a $600 million investment commitment toward the company. (In theory, the sale of an SOE is a one-time government windfall, but the receipts tend to be spread out over time since large companies are usually sold in multiple tranches over several years.) Second, privatization eliminates the need for governments to continue subsidizing loss-making enterprises. In the case of Mexico, government subsidies to state-owned companies accounted for 12 percent of gross domestic product (GDP) in 1982; 10 years later the privatized firms had become net tax payers. It is little wonder governments have grown so fond of privatization programs.

Some critics warn that governments may come to rely excessively on privatization revenue, thus postponing an inevitable day of reckoning when there will be nothing left to sell. In a classic scheme, the French government allocated expected revenues from the partial sale of the state telecommunications firm in 1997 toward pension obligations owed to the company's workers. Such creative accounting helped French officials meet the Maastricht Treaty's budget deficit targets and helped France qualify for first-round admission to the European Monetary Union. This instance notwithstanding, governments generally estimate how much they will take in through divestiture programs over the next year and then plug these figures into their budget targets. Due to the "lumpy" and uncertain nature of privatization, few governments have launched expensive long-term spending programs based on future privatization revenues. Many more governments use these proceeds to repay or reduce their sovereign debt—often the default use of privatization revenues unless they are explicitly earmarked to support new spending.

Privatization Has Shrunk the Economic Role of the State

Yes and no. By definition, privatization reduces the role of state-owned enterprises in the national economy. In developed nations, for instance, the share of SOEs in the economy declined from 9 percent of GDP in the late 1970s to about 6 percent in the early 1990s. However, overall public spending in many countries actually rose during the same period. Among Organisation for Economic Co-operation and Development (OECD) countries, the government's share of GDP has increased during the last 20 years,

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The Perils of Private Pensions

Although privatization is usually associated with the sale of state companies such as banks or airlines, some countries are beginning to divest traditional social services as well. Citing the need to make these services more efficient, governments in developing and advanced nations are transferring the provision of education, health, and even prison systems to private operators.

Perhaps the best known case of social service divestment is Chile's 1981 pension privatization. Workers now finance their retirements through personal investment accounts run by private pension firms—a radical departure from the previous system in which worker contributions funded benefits for retirees. Chile's reform has spawned like-minded efforts throughout Latin America and has even prompted calls for the United States to adopt the "Chilean model" in reforming its own social security system.

With nearly 19 years under its belt, how is Chile's system faring? Supporters emphasize the system's high returns on invested capital—an average of 11 percent annually—as proof that workers will be better off under private pensions. However, this figure masks steep fees and commissions charged by private operators. A study by a Chilean brokerage firm showed that once commissions were considered, workers contributing from 1982 through 1998 actually received an annual average return of only 5.1 percent—less than half the often cited figure. Furthermore, the average worker entering the system since 1990 would have experienced a negative real annual return.

Unlike traditional divestitures—which enable governments to stop subsidizing loss-making state companies—pension privatization is extremely expensive for the state. In Chile, the government must still fund benefits for retirees who spent all or part of their careers under the old system, even though payroll taxes are now diverted to the new private accounts. Chile financed these transition costs through drastic cuts in public spending and by issuing debt. Finally, pension privatization exposes retirees to the whims of volatile markets: When financial markets tumbled in 1998, a senior Chilean official faced the embarrassing task of urging older workers to postpone retirement until financial conditions improved.

Chile's old public pension system suffered from serious financial difficulties and clearly required overhaul. But the Chilean privatization experiment shows that simply transferring social programs to the private sector can raise equally troubling, if different, concerns.

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(the views expressed are his own)

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exceeding 50 percent in some West European economies, even as governments have sold public companies. The state's overall share of GDP in developing countries has also remained fairly steady, even though the role of SOEs was cut from 16 percent of GDP in 1980 to less than eight percent in 1994. The explanation is simple: Privatization has not ended state involvement in the economy, but rather transformed it—away from the direct production of goods and toward greater provision of services and transfer payments, such as pensions and other social safety nets. However, some governments are privatizing these activities as well [see box on previous page]. Privatization enables governments to exit an activity for which they are relatively ill-suited—managing productive enterprises—and instead specialize in redistributive tasks where they alone are trusted to deliver, such as the provision of education, welfare, and health benefits.

Privatization also forces divesting governments to wear a new and sometimes uncomfortable hat: supervisor and regulator of the newly privatized companies. Indeed, the technical demands on the state may even increase after privatization, since governments must move from managing individual companies to regulating entire sectors. The transition is not simple, especially when public officials themselves have grown accustomed to running SOEs for decades with only token oversight. But unless effective and independent regulators discipline the new private owners, many of the intended benefits of privatization could go unrealized. This role is especially critical when governments transfer natural monopolies—such as electricity or gas utilities—to a single private operator who will also enjoy monopoly power, or when companies are granted exclusivity in their markets for prolonged periods. The British experience offers both positive and negative examples of creating a regulatory framework for privatized monopolies. Whereas the U.K. government has been widely praised (and emulated) for the regulatory agencies it introduced for British Telecom and British Gas, the regulatory structures created for divested electric and water companies were more controversial and the privatization of Railtrack has resulted in both deteriorating service levels and higher prices.

Privatization Makes Companies More Efficient, but Harms Workers

It's not that simple. Throughout most of the 1980s, governments launching privatization programs felt they were striking a Faustian bargain: Privatization would yield vastly more profitable and efficient companies,

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but only at the cost of massive layoffs of public employees. The first side of this bargain has certainly held up. Studies document dramatic increases in output, efficiency, profitability, investment spending, and dividend payouts for firms privatized through share offerings, as well as significant reductions in their debts. And new shareholders have experienced positive returns—over and above those earned on comparable shares of private sector firms.

Stark examples of mass SOE firings abound, especially in developing and transition economies. One of the most dramatic instances occurred during the privatization of Argentina's national rail company, when 79 percent of the company's total work force was laid off in 1991 as part of the restructuring of the railroad. A study of more than 200 state companies in Mexico revealed that roughly half of all workers lost their jobs after the government divested its ownership. Such cases notwithstanding, most studies show that aggregate employment remains largely unchanged (or even increases) following privatization programs. Employment in privatized companies does not systematically fall because sales revenues tend to spike as well, thus requiring competent workers. Skilled managers of privatized firms tend to see their compensation increase—through increased salaries and stock options—and workers who stay with the company show significant productivity increases. (The Argentine railway workers who remained on the job, for example, saw their productivity surge by 370 percent in the years immediately following privatization.)

But workers are not just workers—they are also consumers. And consumers in general have benefited tremendously from lower prices, wider access to higher quality services, greater competition, and increased choice—all the result of privatization. The pricing and quality of regulated utilities such as electricity, gas, and water have improved significantly in most privatizing countries. The most important impact may be in telecommunications, where prices have fallen significantly even as more services (cellular, paging, Internet access) become available and waiting times shorten or disappear. After the partial privatization of Greece's telecommunications monopoly in 1996, waiting periods for basic service connections dropped from several months to three days. As changes in the global economy widen the gap between the world's technological haves and have-nots, the enhanced provision of telecommunication services is one of privatization's most significant contributions.

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Ultimately, the social costs of privatization may be less obvious than the number of discharged employees. There is evidence of gender-specific impacts from privatization, for example, particularly in transition economies. One study shows that women bore a disproportionate share of the layoffs that resulted from early divestment programs in Eastern Europe and also suffered from a reduction in SOE-provided welfare benefits (child care, housing, health benefits) that ensued as private owners focused on profits. This experience is particularly discouraging for countries where public companies double as social service providers. For example, a large-scale privatization program in China—where SOEs offer significant benefits and services—would almost certainly generate a large number of losers in the process. Even though a nation's total wealth almost always rises significantly after adopting a privatization program, policy makers face the challenge of softening privatization's negative impact on an often powerless minority of citizens.

Privatization Breeds Corruption

Sometimes. Insider dealings and various forms of corruption frequently bedevil countries that have privatized through vouchers or asset sales. Asset sales are often conducted in a nontransparent manner—such as a poorly publicized sale—giving insiders the chance to manipulate the transaction in their favor. Russia's notorious "loans for shares" program—through which well-connected financiers obtained controlling stakes in the country's most valuable firms for a fraction of their true worth—was the most egregious example of large-scale corruption. The Czech Republic's voucher program failed because of poor design and an inadequate legal structure, enabling managers of "investment funds" (which were established to monitor privatized firms) to loot them instead.

By contrast, privatization programs executed through public share offerings tend to be models of transparency. Governments that choose share issue privatizations almost always hold open competitions not only for the roles of local and international underwriter, but also for the role of adviser to the government on the design of the offering itself. Every step in the process tends to be transparent—most public share offerings are high-profile events and draw significant press attention. Furthermore, as these offerings frequently attract 1 million or more citizen shareholders, governments have a clear political incentive to ensure that the process is, and is perceived to be, free of scandal.

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There's Nothing Left to Sell

Hardly. Although SOEs have been largely eliminated from the economic life of Spain, Portugal, the United Kingdom, and to a lesser extent, France and Italy, much remains to be sold in many OECD countries. Some governments have divested only the least controversial SOEs and have often retained minority (or even majority) stakes in the most important companies. For example, very few West European governments have fully divested themselves of telecommunication monopolies; and most electric and gas utilities remain state owned. Not only do these governments want to retain influence over economically vital and politically sensitive industries, but they must sell large companies in pieces small enough for the stock market to digest—which may take many years to accomplish. Additionally, relatively few of Canada's Crown corporations have as yet been fully divested, and the state sector in the United States (the Tennessee Valley Authority, Amtrak, the strategic oil reserves and national forests, the Army Corps of Engineers, and virtually all municipal airports) remains largely sacrosanct.

By far the most important privatization programs of the future will occur in developing countries. Even in Latin America, where the aggregate volume of divested assets is truly impressive, governments have been very reluctant to sell profitable state-owned firms—especially utilities and national oil companies. The full privatization of oil companies in Mexico and Venezuela alone could raise more than $100 billion. Finally, the three emerging colossi of China, India, and Brazil have only started down the privatization path. Between them the programs they will launch over the next two decades could well dwarf all that has come before.

Want to Know More?

The prevalence of privatization programs in developing and developed economies during the last two decades has led to significant research and analysis. For studies documenting the declining role of state-owned enterprises worldwide, see ***Bureaucrats in Business: The Economics and Politics of Government Ownership*** (Washington: World Bank, 1995) and Oli Havrylshyn and Donal McGettigan's ***Privatization in Transition Countries: A Sampling of the Literature***

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(Washington: International Monetary Fund, 1999). Daniel Yergin and Joseph Stanislaw offer a lively description of the postwar rise and decline of interventionist government policies (including state ownership of productive assets) in ***The Commanding Heights: The Battle Between Government and the Marketplace That Is Remaking the Modern World*** (New York: Simon & Schuster, 1998).

For regional perspectives, see John Nellis' **"Time to Rethink Privatization in Transition Economies?"** (Washington: International Finance Corporation Discussion Paper 38, 1999), Paul Bennell's **"Privatization in Sub-Saharan Africa: Progress and Prospects During the 1990s"** (*World Development*, November 1997), and Graham R. Smith, et al., **"Getting Connected: Private Participation in Infrastructure in the Middle East and North Africa"** (Washington: World Bank, March 1997). Jeffrey Sachs and Wing Thye Woo discuss prospects for privatization in China in **"Understanding China's Economic Performance"** (Cambridge, Mass.: National Bureau of Economic Research, Working Paper 5935, February 1997).

Those interested in the financial performance of state-owned enterprises following privatization should consult Ahmed Galal, Leroy Jones, Pankaj Tandon, and Ingo Vogelsang's ***Welfare Consequences of Selling Public Enterprises*** (New York: Oxford University Press, 1994). William Megginson and Juliet D'Souza summarize various analyses of the performance of privatized firms across 60 countries and more than 50 industries in **"The Financial and Operating Performance of Privatized Firms During the 1990s"** (*Journal of Finance*, August 1999). Studies critical of privatization's impact on individual countries, industries, or firms include Tandon's **"Welfare Effects of Privatization: Some Evidence From Mexico"** (*Boston University Law Journal*, Fall 1995) and David Newbery and Michael Pollitt's **"The Restructuring and Privatisation of CGB—Was it Worth It?"** (*Journal of Industrial Economics*, September 1997).

Several analysts have examined the pricing and method-of-sale decisions of divesting governments. In **"Credible Privatization"** (*American Economic Review*, September 1995), Enrico Perotti describes how policy makers can signal commitment to privatization through their share pricing and share retention decisions. Steve Jones, William Megginson, Jeff Netter, and Rob Nash document how governments use share pricing to assuage political opposition in **"Share Issue Privatizations as Financial Means to Political and Economic Ends"**

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(*Journal of Financial Economics*, August 1999). Florencio López-de-Silanes analyzes pricing dilemmas in Mexico's privatization process in "**Determinants of Privatization Prices**" (*Quarterly Journal of Economics*, November 1997).

Voucher or mass privatization programs in former communist countries are the source of particularly contentious debates. Maxim Boycko, Andrei Shleifer, and Robert Vishny offer an early assessment and defense of these programs in "**Voucher Privatization**" (*Journal of Financial Economics*, April 1994). For critical perspectives, see David Ellerman's **"Voucher Privatization and Investment Funds: An Institutional Analysis"** (Washington: World Bank Working Paper 1924, May 1998) and Bernard Black, Reinier Kraakman, and Anna Tarassova's **"Russian Privatization and Corporate Governance: What Went Wrong?"** (*Stanford Law Review*, forthcoming 2000).

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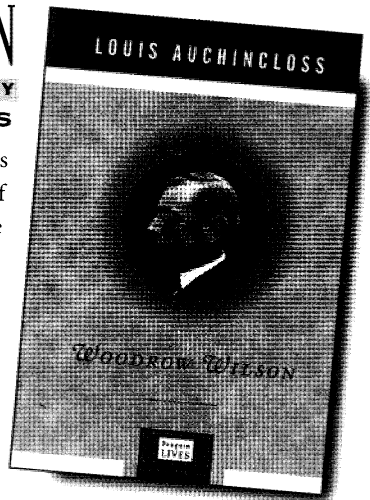

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