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Privatizing State-Owned Companies

Privatization has become a fundamental part of international development over the past several decades. However, in many countries the privatization process did not meet the expectations of the society, the business community, or key reformers. Although it is widely accepted that private firms are more efficient than state-owned enterprises, debates on privatization continue, as newly privatized state-owned enterprises struggle to adapt to the rules of market and fair competition and as the general public becomes discouraged by unfair income and asset distribution.

The benefits of privatization are clear: increased competition, reduced prices, greater efficiency, technological advancement, development of capital markets, reduced pressures on the budget, and an improved ability to finance and provide social services. Yet, in order for these benefits to materialize, the privatization process has to be carefully constructed. Otherwise, corruption can lead to a distribution of assets to a small group of elites, undermining the privatization benefits and societal support for transformation.

This paper reviews the benefits of privatization and the sources of opposition. The examination of several countries' privatization experiences highlights the fact that privatization does work when properly implemented. Privatization, when carried out in an orderly, effective way, benefits regular citizens and can establish credibility, particularly for new governments, among domestic and foreign investors.

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The Center for International Private Enterprise is a non-profit affiliate of the U.S. Chamber of Commerce and one of the four core institutes of the National Endowment for Democracy. CIPE has supported more than 800 local initiatives in over 90 developing countries, involving the private sector in policy advocacy, institutional reform, improving governance, and building understanding of market-based democratic systems. CIPE programs are also supported through the United States Agency for International Development.

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Executive Summary

The last decade saw an unprecedented amount of privatization taking place – according to the OECD, global proceeds from privatization since the 1990s reached a sum of more than $900 billion. But the process is not over – privatization continues to stir-up debates, as state owned enterprises in many countries still dominate economic activity. The negative attitudes towards privatization can be blamed on the problems that surfaced during privatization processes in many developing countries. The reality is that often privatization programs did not benefit the society as they were expected to. Those programs redistributed wealth to the hands of the insiders, while enterprises and industries ceased to exist, workers were left on the sidelines without jobs, standards of living severely declined, and markets contracted. Surveys highlighted by the Center for Global Development illustrate the extent of disappointment in many societies: almost 70% of people surveyed in Russia felt like they were worse off after privatization, in Sri Lanka between 60 and 80% of the people felt like their living conditions worsened, and 63% of people in Latin America don't think that privatization has benefited them in any way.

However, the problems that took place should not be blamed on the privatization process itself, rather they should be blamed on inconsistent policies. In many instances, the legitimacy of the privatization process was undermined by self-centered governments, corrupt managers and directors, crooked government officials, and fraudulent employees who were interested in increasing their own financial wealth rather than the wealth of enterprises and society. Many countries tried to privatize without the sufficient institutions that ensure the protection and enforcement of property rights. That resulted in corrupt privatization processes that transferred enterprises to the hands of the elites and allowed them to engage in asset-stripping. Privatization has also been highly politicized, as governments are often unwilling to give up ownership of enterprises because SOE control serves as a source of political power. On the other hand, the recent history of privatization in developing world presents a great number of success stories as well. In many developing countries privatization is responsible for the availability of modern technology, improved efficiency, safer work environments, and higher salaries. Simply put, when it is done right, it works right.

Empirical evidence proves that good performance by SOEs has been hard to achieve and even harder to maintain. Political, rather than market, control of enterprises historically resulted in SOEs being inefficient, it impeded their ability to advance technologically, and it resulted in their overall inability to compete. Yet, many developing countries continue to maintain government ownership in their key industries and they resist privatization in those industries. It is beyond the scope of this paper to thoroughly examine the process of privatization. Instead, it will concentrate on the benefits of privatization for governments, citizens, and the business communities. It will also present some countries' approaches to privatization and the outcomes of their programs.

Privatization

Privatization can be defined as the process by which governments sell SOEs, completely or in blocks of shares, to private, local, and foreign investors. Although SOEs are the most common and well-known example, governments can also privatize land (some countries in Asia privatized ports), housing (which has been done in Great Britain and elsewhere), and even services (in the United States, for example, many states have successfully privatized education, road construction and maintenance, trash collection, and other services by contracting them out to private firms.)

More important than understanding the process of privatization itself is understanding its underlying rationale – that there are limits to what governments can do, and that some economic undertakings, particularly industrial enterprises, are handled more efficiently by the private sector.

Why do countries privatize? The answer lies in the need to reduce the scope of government in cases where it has grown too big and consumes too many resources to allow the private sector to operate efficiently and function as the engine of growth for the economy. Experience has clearly demonstrated that countries relying on the private sector to generate economic growth have fared much better than countries that have relied on the public sector to do so.

SOEs and the State-Led Approach

State-led strategies for economic growth were popular in the 1950s, 1960s, and 1970s when it was argued that the public sector was better suited than the private sector to foster and manage the industries most essential for economic growth. In addition, SOEs were seen as a way to create jobs, enhance regional development and prevent control of the economy by foreign firms. At first, governments became the owners of industrial and service enterprises in key sectors, such as steel, telecommunications, fertilizers, automobiles, petrochemicals, hotels, airlines and banking. As state-led approaches became more

common, the functions assumed by government grew as well, until, in many countries, SOEs practically dominated economic activity. For example, in Zambia, Burma, and Venezuela, SOEs accounted for more than half of gross domestic investment by 1984. The dominance of SOEs has declined over the years and during the last few years, on average, they contributed around 5-15% of the national GDP in the developing countries. But, there are exceptions - in countries like Romania, where the privatization process did not take off during the 1990s, SOEs contributed as much as 63% of the GDP.

When the public sector controls such a high proportion of economic activity, even in a market system, serious problems in the economy will often result. The experience of many developing countries has followed the pattern as follows:

Lack of Competition

In most cases, SOEs are protected from competition through government regulations that grant them monopoly power in key sectors. Protection is also achieved through high tariff barriers or other measures designed to restrict or eliminate foreign competition.

Lack of a Profit Motive

Because they do not have to face competition, SOEs lack the incentive to provide products or services efficiently. For instance, SOEs are notorious for having too many employees. To cite just one example, in the early 1960s, Egypt guaranteed employment for all college graduates and military draftees: this guarantee meant that Egyptian SOEs ended up with a lot of unnecessary employees. Moreover, jobs at SOEs are often used for political payoffs, which encourages widespread corruption. A related problem with the lack of a profit motive involves the use of SOEs to subsidize consumers, producers, or other groups. Subsidies from governments, for example, allow SOEs to charge below-market prices for electricity, gasoline, or other goods and services. This indirect government support also contributes to SOE losses and represents a drain on public-sector resources.

Lack of Profits

The lack of a profit motive and lack of efficiency – in other words, the absence of discipline brought about through open, competitive markets – has meant that most SOEs in most developing countries have suffered severe, sustained losses. For example, more than half of the over 350 SOEs in Tanzania suffered losses during the 1980s. In Mozambique, 35 percent of total government expenditures went toward subsidizing SOEs in 1986. In Argentina, SOE losses between 1989 and 1991 amounted to 9 percent of GDP – approximately $8.4 billion in 1990. In Tanzania, during 1990s, government's SOE subsidies were more than half of its spending on education. SOEs in Bangladesh lost over $400 million in 1997 alone, which was double government spending on health care that year.

Macroeconomic Imbalances

Large public-sector deficits and foreign-debt burdens are a direct legacy of the poor performance of SOEs in many developing countries. The chronic losses incurred by state-owned firms often force governments to borrow or print money to cover them. These measures lead to high inflation, which discourages investment and causes capital flight. In addition, the government's demand for capital absorbs resources that would be otherwise available for private entrepreneurs, making it harder for the private sector to generate economic growth.

SOEs and Central Planning

Under the system of central planning, the state completely controls all economic activity, which, by definition, means that there is no formal private sector. Experience with this system in the former Soviet Union has shown that markets do not function under central planning. As a result, the competitive discipline that open markets impose on individual enterprises does not exist. This fundamental flaw of central planning has resulted in a host of serious problems for both individual firms and the broader economy as well. Some of these problems resemble those described in the previous section, while others are unique to the socialist system.

Artificial Price Levels

Under central planning, the state sets the prices, instead of allowing the market to determine them. During 1990s, as formerly socialist countries embarked on the transition to market-oriented economies, one of the first steps was a liberalization of prices. In most cases, this step resulted in high rates of inflation, at least initially. Although prices stabilized relatively quickly in some countries, others, primarily Russia, struggled to bring the inflation under control.

Excess Employment

SOEs in centrally-planned economies employed more personnel than they really needed because the government guaranteed jobs for all workers. This guarantee also meant that workers would be paid regardless of their performance. Thus, SOEs were hampered with employees who did not care about the quality of their work. As a

result, worker per wage productivity in ex-socialist countries was well below that of the industrialized countries, the newly industrialized countries, or the more advanced developing countries. This became a serious problem, for these workers had to compete against more productive workers from other countries.

Non-competitive Industrial Base

Central planning left the ex-socialist countries with numerous industrial enterprises that simply could not compete in the international marketplace. After the fall of the Soviet Union, many of such enterprises were forced to shut down due to the loss of state support. Although big declines in production were immediately evident in many of the formerly centrally-planned economies, including the former East Germany, the Baltic countries, and Russia, some large heavy industrial enterprises managed to stay afloat, thanks to bank credits as well as barter arrangements and credit agreements between individual firms. In these circumstances, policymakers faced a difficult choice, because the elimination of such credits would have forced enterprises to shut down, throwing many employees out of work, while extending them would have simply fueled inflation. In Poland, for example, initially the privatization of the large industrial enterprises was put off, and the government kept those SOEs afloat, instead developing small and medium enterprises. But even with the credits, in many countries, such as Romania, layoffs eventually began to increase, as unprofitable SOEs just could not survive by the old rules in the new markets. In addition to these problems, the outdated technologies used by SOEs have resulted in major environmental damage and clean-up problems throughout Central and Eastern Europe and the former Soviet Union. Hungary, on the other hand, was able to quickly sell off its enterprises, and was rather successful at doing so.

Privatization and Economic Reform

Facing the economic consequences of their heavy reliance on the state-owned enterprises, many developing countries have adopted new economic programs, featuring lower barriers to trade and foreign investment and other measures designed to promote competition and strengthen their private sectors. In Central and Eastern Europe and the former Soviet Union, the fall of communism likewise prompted fundamental transitions toward market economies based on private property and private sector development. For both of these groups of countries, experiences of the last decade clearly demonstrate that privatization is closely linked to economic reform, and that it can serve as an important indicator of a government's commitment to reform.

Indeed, it is also clear that, to be effective, privatization must be implemented in conjunction with reforms designed to strengthen the private sector and create more open and competitive markets and economies. Although privatization is not a panacea for all economic problems, when undertaken in conjunction with other structural reforms, it may play a significant role in helping countries achieve greater prosperity. Privatization programs may also serve as an indicator of the progress of a country's efforts to achieve fundamental economic reforms. In 1990-1991, CIPE sponsored a survey of economic reform in 32 countries, covering all major developing regions as well as the ex-socialist countries of Central and Eastern Europe. The survey showed that countries that were successful in launching privatization programs – such as Malaysia, Chile, Mexico, Jamaica, and Argentina – were also among the more successful reforming countries. The experience of transition economies in Central and Eastern Europe in the mid 1990s also proves the point – countries with successful privatization programs, such as Hungary, were more successful in their transition than countries where privatization didn't take off, such as Romania or Bulgaria. However, this does not necessarily mean that an effective privatization program makes an overall economic reform program a success; the key point is that successful privatization involves the management of all the major elements of stabilization and structural reform.

The Benefits of Privatization

Why is privatization an important aspect of economic reform? In simple terms, privatization can improve economic performance and help promote domestic and foreign private investment – the lifeblood of reforming countries in the modern global economy. It also provides new economic opportunities for individuals, who can become investors or part-owners in former state-owned companies. In other words, privatization benefits the public and private sectors and consumers, not just the SOEs that are privatized.

Microeconomic Benefits

Privatization can bring a number of important microeconomic benefits for state-owned firms.

Investment Capital. Many SOEs suffer from a lack of investment, either because of their own chronic losses or because there are simply too many competing alternatives for state funding. Lack of investment is particularly acute for SOEs in heavy industries and in industries that are driven by technology, such as telecommunications. Privatization may bring new capital from the sale of shares and/

or from investments made by the new owners, particularly when the new owners are foreign investors.

Cost Reductions/Improved Efficiency. The elimination of excess personnel undoubtedly makes a major contribution to more efficient operations and improved profits at privatizing firms. Improved efficiency also develops as workers become more accustomed to making decisions and more motivated to work harder, since their jobs are no long guaranteed by the state.

New Management. The managerial capabilities at most SOEs are often below world-class standards. In developing countries, salaries at state firms are usually lower than in the private sector, which therefore attracts better talent. But in many countries the problem is more basic: the managers of state firms simply lack the market knowledge needed to run a firm since most decisions – such as which products to produce, how much to produce, and how much to charge – are made from the above. Foreign investors almost always bring in new personnel. Even in privatizations that do not involve foreign investors, the local owners/investors are free to change managers as they see fit.

Moreover, managers are free to act without having to address the political factors that constrain a government. Because SOEs typically are saddled with conflicting demands, and because their managers are public officials, management cannot always take action to maximize profits, which is the guiding principle of private-sector firms. Although every company faces some political constraints, private firms operate with much greater flexibility, allowing them to adjust more rapidly to changing market conditions.

Technology and Training. New investment and new management will usually carry with them an injection of new technologies. This is particularly important, since, as noted above, many SOEs are hampered by outdated technologies, and by a lack of the investment capital necessary to upgrade them. Similarly, training for both managers and workers may yield great benefits for privatizing firms.

Macroeconomic Benefits

The benefits of privatization are felt not only in the former state firms, but in the private sector and the economy as a whole. For these benefits to materialize, however, privatization programs must be designed and implemented with care. Privatization can succeed only in the context of reforms that create more open and competitive markets. Ironically, market-oriented reforms can destabilize economies in the short term, making a privatization program harder to begin and maintain. The destabilizing aspects of adjustment, such as declining production or rising unemployment, often create political problems. Governments must therefore pay attention to the need to cultivate support among the population for privatization and economic reform in general, for even reform programs that are well-designed technically can fail politically.

Despite the economic difficulties that may emerge over the short term, privatization represents a major step on the path toward economic growth and prosperity over the long term. It will bring a number of macroeconomic benefits.

Greater Competition. Local entrepreneurs are able to enter new markets, as the former state firms lose the special protective measures that shielded them from competition. Foreign investors may also participate in the most attractive markets. The entry of more firms forces all competitors to produce their products and services more efficiently, lowering costs for their customers. This competitive pressure captures the essence of market-based economic systems. However, it is important to keep in mind that the loss of SOE monopolies does not take place automatically – the state must establish appropriate regulatory structures to ensure that there is sufficient competition in the markets where the former state firms operated.

Fiscal Stability. Government finances improve in two ways. Expenditures incurred in subsidizing SOE operations and covering their losses are reduced or eliminated as the SOEs are privatized. Lower government expenditures, in turn, reduce the inflationary pressures that destabilize economies and undermine reform programs. On the other side of the ledger, governments can generate revenues from the sale of state firms. In Russia, for example, the sale of small businesses has yielded significant revenues for local governments. Some governments, to maximize the revenue gains from the sale, attempt to restructure their SOEs before they are sold. This approach can be unsuccessful, as described later in the case study of privatization in Zambia, or successful, as it happened at times in China, where some SOEs, although under government control, are slowly introduced to market operation techniques.

Through the use of financing techniques such as debt-equity swaps (in which foreign creditors exchange their debts for shares in state-owned firms), governments may use sales of SOEs to alleviate their foreign-debt burdens. In addition, should these privatized companies become profitable, governments can generate increased fiscal revenues through corporate taxation.

Statistics from several countries demonstrate the fiscal benefits of successful privatization for developing countries. After the launch of its privatization program, Argentina experienced a marked improvement in its non-financial public sector deficit, which declined from

7.2 percent of GDP in 1989 to 4.9 percent in 1990 and an estimated 0.7 percent in 1991. The experiences of Argentina in 1990s stressed the importance of sustainable reforms. In the early stages of privatization, the privatization proceeds were used to finance government deficit. But as the sales of enterprises and, subsequently, the financial flows from privatization declined, Argentina's budget quickly appeared to be on the verge of collapsing, because it was not reformed, but rather financed through volatile funds – privatization proceeds. In Mexico, before the privatization process, the government was spending as much as 16% of its GDP on keeping its SOEs afloat, but with the successful privatization by 1994 those enterprises became net contributors to the budget. In Philippines, by 1994, eight years after the start of the privatization program, privatization generated more than $6 billion in revenues for the government, and it was responsible for the first fiscal surplus in 20 years. In Jordan, for example, by 2002, privatization proceeds reached almost $900 million, and, according to some estimates, other fiscal benefits yielded additional tens of millions of dollars through elimination of financial support for loss-making SOEs and additional millions of dollars through taxes from privatized enterprises.

Such improvements in fiscal stability are evidence of the success of economic reform programs. Of course, it would be misleading to assert that privatization is the only reason for these favorable results. The key point is that successful privatization goes hand-in-glove with successful reform programs. Fiscal stability, for example, is a major aspect of keeping high inflation in check, which, in turn, goes a long way in establishing a stable macroeconomic environment.

Capital Market Development. The relationship between privatization and capital markets is complicated, but important. Generally, privatization programs will not enjoy success on a large scale in countries with underdeveloped capital markets. In countries with small stock markets, for example, it is difficult for newly-privatized SOEs to sell their shares to local or foreign investors. It is also difficult for investors to dispose of shares once they are acquired, making them more cautious about doing so. Workers are less enthusiastic about share ownership in these situations for the same reason.

However, some countries have had success in using their privatization programs to create large blocks of shareholders, which, in turn, can help develop local capital markets. Chile, for example, privatized its public pension system, which created private pension funds that served as institutional investors. Poland and the Czech Republic have tried similar approaches in creating investment funds. Institutional investors help promote greater volume and liquidity in local capital markets and also exert greater influence than individual shareholders on the management of the firms in which they invest. (In theory, making the management of a firm more accountable to the firm's shareholders makes the firm operate more efficiently.)

Social Programs. The sale of SOEs enables governments to employ the resources previously consumed in keeping them afloat for other purposes. For instance, funds can be used to pay for the social safety nets that are important in cushioning the impact of adjustment on the population and thereby maintaining popular support for economic reform. For example, the Solidarity Pact in Mexico, under which in late 1980s the Salinas government agreed to establish support programs in exchange for business and labor cooperation with the reform program, has been funded with proceeds from the privatization of SOEs.

Attracting Foreign Investment. Despite the destabilizing effects of privatization and economic reform programs in the short term, an effective privatization program stabilizes a country's fiscal situation and economy over the long term. A stable macroeconomic environment, in turn, is a key aspect of attracting foreign investment, which may bring many important benefits for recipient countries, including technology transfer, job creation, and export development. These three objectives are critical to future economic growth and development. Shortages in the amount of global capital available to finance worldwide growth and development means that the attraction of foreign investment is crucial. The desire to attract foreign investment has been a major motivating factor in developing countries' efforts to implement market-oriented reforms and the ex-socialist countries' movement toward market economies.

Benefits for Foreign Investors

Privatization offers important potential benefits for foreign investors, and many countries have designed their privatization programs to maximize foreign participation. Nonetheless, a privatization program by itself may not be a sufficient condition for attracting foreign capital, as foreign investors evaluate many other factors, including the overall economic climate and political stability.

The major attractions of privatization for foreign investors include:

New Markets. Privatization provides foreign investors the opportunity to penetrate new markets in developing countries and regions. The long-term growth and earnings potential in many of these markets is higher than in the mature, highly-saturated markets of the industrialized countries. A cheap and plentiful supply of both skilled and

unskilled workers in these countries may help foreign investors create export platforms that are a strategic necessity in today's competitive global economy.

The acquisition of state-owned firms can help foreign investors establish operations much more quickly than investing in a new plant from scratch, a process often referred to as a "greenfield" investment. Foreign investors may also capture a ready-made share of new markets through the purchase of SOEs. In 1991, PepsiCo's acquisition of a majority stake in Wedel, a well-known Polish confectionery, allowed the company to take advantage of an established, well-respected brand in penetrating markets throughout Eastern Europe.

It should be noted, however, that establishing a joint venture with a privatized firm is not always preferable to starting an overseas operation from scratch. Privatization may involve high costs for foreign investors—it may take a long time to complete the process, and foreign firms may be required to pay SOE debt, address hidden environmental problems, pay enterprise restructuring costs, and streamline cumbersome worker-management relations. Many companies, in fact, prefer the greenfield approach.

Lower Risk. Through techniques such as joint ventures of the acquisition of minority stakes, privatization shields foreign investors from extensive capital outlays and from the higher risks and other drawbacks involved in greenfield investments. It may be particularly difficult for greenfield investments to succeed when investors must deal with labor unions or local government officials who oppose reforms or foreign investment in general. Land acquisition exposes investors to the risk of expropriation, and permits must often be obtained through tangled bureaucratic procedures.

Lower Entry Barriers. The acquisition of a state-owned firm may be preferable in capital-intensive industries, which have high start-up costs and entry barriers. This strategy may also be apt in countries with poor supply and distribution networks. In Poland, for example, Gerber, an American baby food producer, purchased a majority stake in Alima, a local producer, to take advantage of the company's existing supply and distribution system, including strong connections with local growers and a glass factory. The new company quickly became one of the leading children food suppliers in the new European markets.

Benefits for Consumers

Consumers benefit when state-owned firms are privatized as well. A firm that is forced to compete (by losing monopoly privileges) and that receives new investment capital, management, technology, etc., should provide better services at lower costs. For this competitive pressure to result, however, the privatization process must be structured in ways to ensure that public monopolies are not replaced by private ones. For example, in many of the ex-socialist countries, where SOEs dominated the economy, privatization has been carried out through fragmentation or other techniques that have broken up large SOEs into smaller firms to prevent their continued monopoly power. Similarly, high tariffs or other barriers that keep out competitors must be reduced or eliminated.

The Costs Of Privatization

With this array of potential benefits—for governments, the economy, the private sector, and consumers—a person not familiar with privatization might be tempted to assume that the process has been eagerly embraced in every country where it has been attempted. Yet, experience has shown that the opposite reaction is very common: privatization has been very controversial in almost all countries that have undertaken it on a large scale. Even in countries that have had success with their privatization programs, implementation has come only after monumental political struggles.

Why is privatization so controversial and difficult to implement? In a nutshell, privatization carries numerous costs that some elements of a society are simply unwilling to pay. Opposition results from social sectors that benefit from the current economic system. Those sectors often fear that the changes associated with privatization and restructuring will have a negative impact upon them.

Hardships associated with economic restructuring are not new. During the 1980s, austerity programs imposed by the International Monetary Fund (IMF) as a condition for further lending aroused widespread political opposition in many countries. Since privatization usually is attempted as part of broader economic restructuring, opposition to it typically reflects opposition to the hardships associated with restructuring as a whole. Moreover, privatization is a highly visible element of an economic restructuring program – compared to a tight monetary policy – and, therefore, attracts more attention and political opposition.

Without a doubt, the difficulties associated with privatization and restructuring – which may include higher unemployment, declines in industrial production, and higher inflation – are not easily borne by the general population. In most cases, economic restructuring and/or privatization are not attempted until economic conditions have deteriorated to the point that current policies cannot be continued. Thus, populations that have suffered under old policies are asked to suffer under the new ones as well with only the promise of future gains as a selling point for

the new programs. In countries new to democratic political systems, governments and political institutions are not strong or well-established enough to withstand a great deal of political pressure.

Sources Of Opposition

Three major sources of opposition to privatization and restructuring are labor unions, industrial managers in state-owned industries, and political groups of a nationalist or populist bent.

Many workers in state-owned firms have to pay high social costs, as privatization may involve job losses and the introduction of new work rules, including longer hours and reduced benefits. In many countries undergoing privatization, high unemployment represents a serious hardship; alternative work opportunities are scarce as a result of the implementation of structural adjustment reforms or the transition to a market system. This problem was of a particular concern in Central and Eastern Europe, especially in Eastern Germany and in the former Soviet Union.

For state-owned firms, the elimination of subsidies, loans, and other government support - which, in most cases, enabled them to continue operating despite chronic losses – represents a significant threat. It is important to remember that particular industries have gained government support through their political connections. (This is a critical problem when there is a large government role in the economy.) Officials in the major industrial sectors usually command a great deal of political power, based not only on personal relationships with government officials, but on their ability to form distinct constituent groups with firm policy positions. The ties that exist between industry and political circles were especially close in Russia during 1990s. The Union of Industrialists and Entrepreneurs, made up primarily of managers of state-owned firms, was able to form coalitions with trade unions to slow the more radical pace of reform.

Another serious, yet less tangible, barrier to privatization is directly related to the question of national sovereignty and its relation to economic security. In the developing and ex-socialist countries, domestic investors often lack sufficient capital to invest in privatizing firms, thereby arousing concern that privatization will mean handing over the "national patrimony" to foreign investors. The foreign control of SOEs, a common outcome in privatization, evokes fears of political manipulation and/or economic sabotage that have been commonly associated with multinationals in the past. The repatriation of profits feeds these fears, as funds obtained from local operations, rather than being reinvested to support the local economy, are often taken out of the country.

Privatization Experiences

Each country embarking on a privatization program faces the choice of which of its SOEs to privatize, how to divest the assets, and the parties to whom the assets will be sold. On a broad level, the strategy will reflect the objectives of the country's privatization program, which, of course, will be unique to the political and economic circumstances of each country.

Determining the appropriate privatization technique is a complex question, as firms operate in different environments and under different circumstances. For example, if a firm is showing large losses, has outdated technology, and strong labor unions, it is much harder to sell. In some cases, privatization may have to proceed through a series of stages involving several of the techniques described above.

The following sections discuss specific approaches to privatization and illustrate the particular conditions and contexts various privatization programs face. These peculiar conditions result from differences in economic climate, culture, and policy, as well as from the differences in the kinds of firms to be privatized. As a starting point, it is useful to recall that the seven approaches described above are typical of developing countries. In the ex-socialist countries, different economic and political circumstances have dictated unique privatization methods—such as mass privatization through vouchers or investment funds, large-scale privatization through state holding agencies and small-scale privatization through auctions—in addition to the approaches commonly employed in developing countries.

Privatization in Egypt

Egypt's privatization program was identified as one of the keystones in its economic reform process in the early 1990s, when the country was trying to fit into a rapidly changing world environment. Partly, the privatization process was mandated upon Egypt with the IMF assistance in 1991, when one of the conditions under which the loans were provided was a requirement to privatize. Yet, more importantly, poorly performing SOEs were a drag on the economy of Egypt and they required substantial financial resources to keep them afloat, the resources that the government could no longer provide. Throughout 1980s, SOEs, GDP share of which was around 40%, were receiving the majority of investments in the economy, but the rate of return on those investments was less than half of the interest rates at that time. However, although there was a general realization of the need to restructure, the process wasn't an easy one to implement. The country

Privatization Techniques

Having examined the rationales for and benefits and costs ascribed to privatization, it is important to look at how privatization itself is carried out. Privatization programs may employ a wide range of techniques and options. There are seven basic approaches to privatization:

1. The public sale of shares in an SOE
Although public offerings can be more difficult and costly in countries with weak capital markets, large-scale publicity campaigns can overcome this obstacle. In Jamaica, for example, a publicity program helped make a success of the auction of a fairly profitable government-owned bank.

2. The private sale of shares in an SOE
This type of privatization is quite common and should take place through a competitive bidding process to avoid the common problems of corruption and favoritism. Controversy surrounded some of the early Mexican privatizations because of allegations that firms were sold to friends of the ruling party at heavily discounted prices. This has also taken place during privatization processes in the former Soviet Republics and especially in Russia, where the lack of transparency in privatization process has resulted with SOEs in the hands of the insiders.

3. New investment in an SOE
Purists do not actually consider this a form of privatization since the government often retains a controlling interest in the firm, which can affect investment decisions critical to future success. The new investment can be undertaken either through a public sale of shares of through private placements.

4. Selling off assests of an SOE
This effectively liquidates the company and wipes out its outstanding debts. The assets can then be repackaged for sale to investors, but for a lower price than the value prior to liquidation. This approach is usually followed only when there is clearly no hope that the firm can be saved through internal restructuring. Poland has made extensive use of this method for its industrial sector.

5. Selling components of an SOE
The profitable parts of the company are then sold as separate firms. Many of the centrally-planned economies featured large holding companies consisting of many different kinds of enterprises. These holding companies have to be broken up and recombined before any other type of privatization takes place.

6. Management and/or employee buy-out
The most well-known method is the Employee Stock Ownership Program (ESOP), where a new firm is put together by employees pooling their resources and borrowing new funds. This new firm then buys the existing state-owned firm, thereby making it privately owned. ESOPs have often been used in the United States because of special tax incentives. ESOPs have been used as a means of protecting against hostile takeovers or to minimize unemployment when the alternative is liquidation.

7. Leasing the operation of an SOE
The leasing of a state-owned firm to a private operator or the conclusion of a management contract between an SOE and a private firm, with the actual ownership of the firm's assets and liabilities remaining with the government. These approaches, which have often been used in African countries, have some long-term limitations. In Côte d'Ivoire, for example, private management, through a leasing contract, improved efficiency in the water supply. However, this improvement was only temporary as the government continued to administer investment and maintain discriminatory pricing policies. Overall, entering into a management contract with the government usually results in less control for the firm running the operation, since the contract allows the government to specify the terms and conditions under which the firm must operate.

faced a known set of problems – weak and unprepared for transformation process legal base, frail stock market mechanisms, and lack of political unity and support for privatization. Government insiders, who were heavily involved in exploiting public enterprises, were not interested in changes. Also, employees and managers resisted changes as well – privatization of the overstaffed SOE's was bound to leave a large number of them unemployed.

Egypt, unlike some developing countries that rushed into large-scale privatization process, focused on a step-by-step gradual approach that allowed for a greater control of the process itself. While some experts have criticized this cautious approach to privatization, many consider Egyptian privatization, compared to many failures in the developing countries, a more successful one. Originally, the government offered 316 companies for privatization, of which a majority was profit-making. A total of 133 companies were fully privatized by 2003, while another 55 were partially privatized, and the privatization proceeds totaled $3.4 billion. The majority of the proceeds went to the Egypt Ministry of Finance (45%), while 18% were used for early retirement pensions, over 30% for SOE debt settlements, and less than 5% was spent on the restructuring. The privatization program started off slowly and picked up in late 1990s, when almost half of all the companies were privatized.

The government employed several different privatization techniques: 28% of companies were privatized through shares offered on the stock market, 22% through sale of a company to an anchor investor, 26% through sale to the Employee Shareholder's Association (ESA), and 24% by the means of liquidation/bankruptcy with subsequent sale of assets. In the case of ESAs, after the Ministerial Privatization Committee evaluated the enterprise, a company would be sold to ESA at a discount (which could be as high as 20%) with a payment deferred for 10 years. Therefore, official privatization proceeds do not include the companies sold to ESAs. In the case of 55 partially-privatized companies, the government used minority IPOs and lease contracts, which allowed the private sector to manage companies while they still were owned by the state. This was generally done with weak, inefficient, and unprofitable enterprises for which it was hard to find an investor. Generally, when the lease contract expired, the lessor was given an option to purchase the company. The majority of the companies sold to strategic investors were turned into profitable and competitive enterprises in a short amount of time. SOEs that were transferred to ESAs did not perform as well, since the government influence was still significant in those firms, and in fact, in two instances, ESAs transferred their shares back to the government.

After a boom in privatization in the late 1990's, the process stagnated and not much improvement was seen. Selective privatization, employed by the government of Egypt, has been one of the reasons – the government still retains control over big and important enterprises, while only willing to give up the ownership rights to smaller companies. Most of the more attractive enterprises have already been privatized, and the ones that government is offering for sale are simply not attractive for many investors. Also, there is a concern about how the government is spending the privatization proceeds – the statistics suggest that the funds are often used by the state to finance the loss-making SOEs, not to restructure.

There are several real impacts of privatization on the economy of Egypt. Most importantly, trying to jump start the privatization program in the early 1990s, the government developed a key set of rules and regulations, built a privatization culture in the country, and facilitated development of key institutions. Privatization and subsequent improvement in the investor climate aided a creation of a strong stock market. The number of companies listed jumped to 1,100 in the 2003 from less than 700 in 1991, and the market capitalization of those companies rose from $3.2 billion in 1992 to almost $20 billion in 2003. SOE performance greatly improved – the number of loss making enterprises decreased by more than 50%, and the rise in return on investment was four-fold. Workforce in enterprises offered for sale decreased from roughly 1 million in 1991 to less than 500,000 by 2001, as privatized companies moved away from the legacy of the guaranteed public sector employment. Yet, the effect of the privatization on the labor market has not been negative. As estimated by CARANA, a leading expert on country's privatization program – many of the 500,000 who lost jobs in privatized companies retired, since the government used some of the privatization proceeds for early retirement programs, and others have successfully obtained new jobs in the private sector. In some cases companies even increased their employment after privatization as they took on new markets and new opportunities. The financial burden of the under-performing SOEs on the government was reduced, and privatization had a positive effect on the development of markets, competition, investment climate, and trade. Overall, the slow approach to privatization has mostly been successful in Egypt, allowing the country to avoid many of the problems that surfaced in privatization processes in Eastern Europe and Russia. However, the key now is to build on the experience, reduce government control in several industries, and privatize on a larger scale.

Privatizing the Social Security System in Chile

In the early 1990s, after nine consecutive years of growth and with a growth in GDP of more than 10% in 1992, Chile enjoyed one of the Western Hemisphere's healthiest economies. The country set the stage for this remarkable performance back in the 1970s, when the government began an economic transformation that abandoned the state-led model in favor of lower trade barriers, more competition for local firms, and privatization.

A key element in the success of Chile's program was the privatization of the social security system in 1980, when private pension funds replaced the government social security program. With the creation of the private pension funds workers entering the workforce had to deposit money in their personal retirement accounts, which financed their retirement income. The new private pension funds have brought better returns for investors compared to the old system, along with greater uniformity in administrative structure and more efficient benefit distribution. In addition, the new system has stimulated domestic savings, as well as the development of Chile's capital markets, which, in turn, have strengthened domestic investment and economic growth.

The previous system, originally adopted in the 1920s, was composed of 32 benefit funds and had been plagued by high worker-contribution rates (i.e., taxes), low-quality services, and little redistribution of benefits across income sectors. While the old system was generally progressive, inequities in contribution requirements and benefit distribution favored privileged sectors and political pressure groups. Since most of the old funds were managed inefficiently by government employees who did not have to respond to competitive pressures, they typically offered poor service for their customers as well as poor financial performance.

The rights to operate the new social welfare system were given to a privately-owned Pension Fund Administrators (PFAs), while the government functioned as a safety net and regulatory agency. Workers are required to contribute 10 percent of their earnings to a PFA but are free to invest in the PFA of their choice. Workers also contribute 3% of their income for life and disability insurance. PFAs compete on the basis of financial performance, quality of service, and fees. Contributors' benefits are determined by the accumulation of their individual savings accounts and by the profits derived from the funds' investments. To provide benefits to needy individuals who cannot contribute to the system, family allowances, welfare pensions, and unemployment compensation are financed by separate funds capitalized with tax revenues.

The government oversees and backs the operations of the PFAs to ensure fairness and stability. It acts as a "guarantor" by determining a minimum pension level, supplementing individual funds that lack sufficient capitalization, and protecting the funds from bankruptcy. Also, the government plays a role in minimizing risk by establishing legal restrictions on the composition of the investment portfolio; a separate body, the Risk Classification Commission, was created in 1985 to evaluate and approve the funds' investments in the capital markets. The increased reliance on individual contributions has enabled the government to focus its resources toward the poorer segments of the population who did not qualify for minimum pension levels, which are around 75% of the minimum wage.

The new pension funds have dramatically increased the benefits paid to contributors. For example, retirement pensions have exceeded those of the old system by about 35 % within a few years. The real income-yielding capacity of the pension funds between 1981 and 1990 reached an average annual rate of 13 %, well above the real average annual interest rate of 8.7 % (which could be earned through bank accounts) during the same period. Today, a majority of the workforce has joined the private pension system (over 95%, compared to the original estimates of no more than 50%) and the average real rate of return has been almost 11%. The fact that such a great proportion of workers have joined the system speaks for itself. But more importantly, the new pension fund system has positively affected domestic savings and contributed to a better productivity of capital.

The new system features a greater degree of competitiveness, as contributors are free to invest their money in any of the 32 funds. The returns on the investments and the variable part of the commission structure are evaluated by pension-fund participants in their choice of funds. Although the law requires the funds to maintain a certain portfolio composition, there is enough freedom to allow for variations in yields. The fact that pension funds can offer similar returns on investments, lock in several benefits of the healthy private sector competition for the customers forces the funds have to compete for workers' savings by offering lower commission, better customer service, and higher quality products.

The system stimulated the development of the Chilean capital markets by increasing domestic savings and channeling them for investment in market instruments through the private pension funds. To minimize the risks associated with investments, to ensure portfolio diversification, and to establish effective anti-fraud and anti-theft mechanisms, the government set some limits on investments – for example, no more than 50% of PFA investments can go to treasury notes, no more than 45%

can go to private or public company bonds, no more than 25% can go to the real estate investment funds, and no more than 40% can go to common stock investment funds – and made sure that PFAs cannot be involved in any other activities besides managing pension funds. Although there is a limit on the maximum investments in the government securities, the funds are not required to be invested in government securities and can be fully invested elsewhere. The government guarantees a minimum return on investment, which cannot be more than 2% below the industry average within the previous 12 months. Also, workers' investments are safe if any of the PFAs would collapse, because their assets are separate from the fund's assets.

The funds have helped finance a significant amount of private-sector activity and the expansion of the Chilean economy as a whole. The private pension system has increased the efficiency, transparency, and scope of Chile's capital markets, which has also served to facilitate privatization in general. In addition to investing in newly-privatized firms, PFAs have improved the liquidity of Chile's capital markets, making the newly acquired shares of SOEs easier to sell, which also made them more attractive for potential investors. Liquidity is an especially potent issue for foreign investors, who have been important participants in Chile's privatization program, through debt-equity swaps and other techniques.

Despite noticeable improvements in the retirement system, some difficulties remained in the early stages. The government continued to be responsible for making payments to recent retirees at the same time it was making payments to those who retired under the old system, paying for transfer bonds to move contributions made under the old system to the new system, and supplementing the difference between individual contributions and the established minimum pension level. The overlap between the two systems created additional operational and administrative costs, although, these costs were eliminated over time, as the system matured.

Also, despite simplified cost structures, the fixed portion of the commission rates acts as a regressive tax that is especially detrimental to the middle- and low-income groups. High-income groups can enjoy a high yield based on their contributions to the system. On the other hand, individuals with lower incomes must contribute a greater proportion of their income to the system, thereby limiting their yields. Although the government supports the lowest income groups through minimum pension levels, no such protection is available to the middle class. One of the solutions to reduce a tax effect on the middle-class is to eliminate specific cross-income contribution rates and set them as a percentage of the individual's income that makes the contribution equal the amount of the minimum pension. Politically-motivated government intervention still poses a danger to the system in transfer-bond distribution, changes in retirement eligibility, and establishing minimum pension levels.

Finally, the returns on the funds can be only as attractive as the investment opportunities and macroeconomic climate. The local capital markets offer limited investment opportunities to the PFAs because of government regulations. Thus, one of the solutions being offered is to allow banks and other financial institutions to participate in pension fund management, which will further reduce operation costs. In this case, the government should also lift the restrictions on investment, allowing the funds to be invested in more private companies and foreign stocks. Through these measures, the government will rely on the PFAs even further to finance Chile's growth.

Restructuring State-Owned Firms in Zambia

Zambia represents a classic case of the pitfalls of the state-led approach to development, a model that brought the country a bloated public sector and the attendant fiscal problems. The government of President Frederick J. T. Chiluba, who was elected in October 1991, initiated a structural adjustment program with privatization as a central component of the reform effort. The program targeted 90% of Zambia's SOEs for privatization within five years and the remaining SOEs were to be restructured. Progress in privatization, however, has been slow from the start, with opposition building and the government lacking a strategy to build public support for the process.

The economic decline attributable to state-owned firms could be traced back to the early 1970s, when Kenneth Kaunda nationalized the copper-mining industry and used the revenues from this operation to create a large holding company, the Zambia Industrial and Mining Corporation (ZIMCO), that assumed control over 120 SOEs. By the early 1990s, the public sector came to control nearly the entire Zambian economy – 80 percent of the industrial work force was employed, directly or indirectly, through the public sector, and SOEs accounted for 80 percent of industrial output and generated 93 percent of Zambia's foreign exchange. The copper mines alone provided 80 percent of the country's foreign exchange, despite having outdated technologies that reduced productivity.

The dominant role of the public sector created serious economic distortions. Tight wage and price controls disrupted supply and demand. Financial restrictions, trade barriers, and extensive local regulations were used to restrict competition and create SOE monopolies. The majority of these companies lost money and were kept afloat

Corporate Governance in a Privatization Process

As countries in transition face the need to privatize, a special attention must be paid to the mechanisms that ensure the legitimacy of the privatization process. Absence of corporate structures and weak corporate culture hinder the privatization process. After all, how do you get people to invest their money into companies when the mechanisms that protect their rights as investors are not functioning? Such mechanisms were often taken for granted by those who put together the reform programs, and many countries failed to take the importance of such mechanisms into account when designing privatization programs in the developing world. As a result, the privatization processes not supported by corporate governance reform usually ended up happening behind closed doors, among few insiders who are close to the decision makers.

There are many examples of privatization in developing and transition countries not meeting original expectations. Often managers and employees are the ones who gain control over enterprises by exploring legal loopholes in dated regulations and outside investors are not even given a chance. This leads to insider control, which, in turn, is an open doorway to asset-stripping and insider self-dealing. Moreover, the absence of corporate governance structures often leads to abuse of the minority shareholders' rights, and such actions are bound to undermine the legitimacy of the privatization process in the eyes of the public.

What is corporate governance and what effect does it have on privatization process? Corporate governance is generally defined in terms of issues that result from separation of ownership and control in organizations. Corporate governance sets up a system that governs the relationships between owners of capital and managers, as well as managers and other stakeholders, and it concentrates on protection of shareholder rights and independent supervision over activities of a business entity. It brings a system that is based on transparent operations and the rule of law, fairness and responsibility. Importantly, corporate governance sets up a system where rules are enforced not only by written regulations, but also by moral standards of business ethics and by responsible corporate behavior.

Corporate governance helps privatization by ensuring fairness in the process. It is of most importance in the situations where mass privatization results in a dispersed ownership. In such situations corporate governance is the only way for owners to ensure that employees and managers are acting in the interests of the organization, not their own. Corporate governance introduces mechanisms and institutions that protect integrity and ensure legitimacy of privatization. Those mechanisms protect the rights of minority shareholders, oversee activities of top management, introduce rule of law, fight corruption, and provide fair and transparent dispute resolution instruments. They also hold managers, employees, shareholders, and directors accountable for their actions. Corporate governance practices develop and improve institutions that are vital to the overall success of privatization. There is no one right structure of corporate governance. When establishing systems of corporate conduct, countries should pay attention to the specifics of their own markets rather than directly adopting corporate codes from other nations. Yet, at the center of any governance code should be the concepts of accountability, responsibility, fairness, and transparency.

For more on corporate governance please visit www.cipe.org.

by direct government subsidies, creating an enormous budget deficit and preventing the private sector from gaining access to domestic capital. The tide of debt forced the new Chiluba government to adopt a structural adjustment program under the auspices of the World Bank.

Yet, despite the overwhelming need to reduce the size of the public sector, progress in the early stages of the Zambian privatization was slow, largely because of an original strategy that emphasized reforming and restructuring SOEs rather than an actual transfer of ownership. The government maintained ownership of the firms as a means of controlling employment and the movement of foreign exchange, using management contracts and restructuring to attempt to improve profitability. This strategy led to delays in the overall reform of the economy, as Zambia's fiscal imbalances worsened due to the continued payment of subsidies, assumption of further losses, and loss of revenues from actual divestitures. An addition, by not divesting, the government prevented the firms from obtaining new technologies and investment and left them susceptible to politically-motivated decisions, factors that dampened efforts to improve their operating efficiency.

Eventually, the government realized the futility of attempting to reform SOEs that continued to realize huge losses. The new privatization program was introduced and it quickly gained speed and vitality by focusing on actual

transfers of ownership, with emphasis on enhancing the participation of Zambian individual investors as much as possible.

The first step in the privatization process was the Privatization Act of 1992 passed by the Zambian National Assembly. The Privatization Act established Zambia Privatization Agency (ZPA), which replaced the steering and technical committees from the previous government and the purpose of which was to plan and coordinate the privatization activities. The agency was not a government entity, rather, it was created to ensure the private sector participation in the privatization process – the government appointed only three members (out of 12), and the rest were the representatives of the private sector organizations such as the Federation of Employees, Confederation of Chambers of Commerce and Industry, and the Bankers Association of Zambia. Also, the law specified the activities of the ZPA, specifically, it ensured that all operations as well as enterprise-bidding must be concluded in a fair and transparent manner. The Act was constructed to protect the small investors – it prohibited insider trading and government officials by law were required to state publicly their interest in a company so they will not be able to take advantage of their privileged access to information.

The privatization process was done in several stages. First, ZPA chose the companies to be privatized and makes a selection on the privatization method. There were a number of privatization techniques to be used, all which were included in the Privatization Act: public offering of shares, private sales of shares through negotiated or competitive bids, issue of additional shares to dilute State's ownership, sale of selected assets, reorganization/breakup of the SOE, management/employee ownership, as well as lease and management contracts. The next step was publishing the privatization note on the chosen SOE in the Government Gazette and acceptance of the applications from the potential investors, the purpose of which was to ensure that only those capable of running the privatized company would participate in the process. After approving investors for participation in the bidding process and providing them with the necessary evaluation reports, ZPA allowed anywhere from 4 weeks to 3 months for potential investors to further investigate companies for sale and prepare their bids. After accepting and evaluating the bids, ZPA chose the investor and signs a sales contract. After the contract is signed, to ensure fairness of the process and transparency, ZPA published all the information regarding the process (participants and their bids, as well as prices of shares and other relevant data) in the Government Gazette.

Originally, the government decided to offer 150 state-owned firms for sale. As of October 1992, bids for the first group of 19 small companies were closed. It was hoped that initiating the process with small companies would enable Zambian officials to develop the expertise necessary to divest the more complex, larger companies. In the early stages the process was slow, mainly due to concerns that privatization would put a lot of people out of work. However, the effect of the privatization on employment has been minimal, in fact, in some cases privatization worked to the benefit of workers since if not privatized, companies could be liquidated because of their financial burden on the government, and in that case all company employees would be out of work. As the benefits of privatization became more evident and the public support for the program strengthened, the process slowly picked up by mid 1990s. The major signal that privatization was real was closing of the country's giant ZIMCO, which contributed more than 50% of GDP alone, in 1995 and by the early 1997, 167 companies were already privatized. By January 2003, over 250 companies were privatized, and an additional 24 companies are currently slated for privatization.

The privatization program in Zambia has achieved some impressive results, and it is considered to be one of the most successful on the continent. Most of the enterprises (97%) became successful profit-making companies within a few years after the privatization, and they have also attracted foreign capital in other industries. More importantly, the privatization program has worked to the benefit on the private sector, and it has stimulated economic activity in many sectors, especially in agriculture. It helped reduce budgetary pressures on the government, and through increased economic activity helped to spur growth – in 1993, the year after privatization process was launched, Zambia achieved a real GDP growth of 5.1%, compared to negative growth in the previous years. Throughout 1990s and into the 21st century Zambia enjoyed a relatively stable economic growth and the government influence in the economy has been greatly reduced.

The major point is that the initial Zambian attempt to restructure SOEs to maintain employment, justify past expenditures, and maximize revenues led to continued losses and delays in the overall reform process. While a quicker approach to selling state firms led to smaller revenues at the moment of sale and has temporarily aggravated unemployment, in the long-run it benefited the economy. In many privatized companies, productivity greatly improved within few years and instead of consuming government funds they started to contribute money to the budget. In the long-run, privatized companies positively affected employment by securing old and creating new jobs.

Infrastructure Privatization: Brazil & Argentina

Privatizing infrastructure has its benefits: governments that allow for privatization of state-run infrastructure companies see increased quality of service, lower prices and operational costs, increased levels of technological development, greater transparency and openness, and improved and advanced management techniques. Afterall, corporations don't have governments covering their losses – they have to be competitive and technologically up to date in order to be profitable. When markets are not restricted, healthy competition leads to lower prices.

Why should governments privatize infrastructure? Low quality of service and great budgetary pressures are just some of the reasons. There are several issues, especially in developing countries, that put great pressure on the governments not to privatize SOE's that provide services. The risk of failure is perhaps the most important of all since if the privatized company fails, citizens may loose access to basic services, such as water or telephone. And while privatization brings greater efficiency and increases productivity and profits, it also brings restructuring that often leads to downsizing of companies and subsequent layoffs of employees.

Energy Sector in Brazil

In Brazil almost 90% of the electrical power is generated by hydropower plants and with the expansion of Brazilian economy and the growth of demand for electricity that exceeded GDP growth in the 1990s, the country faced a problem – the state run energy sector was no longer able to increase its capacity and satisfy the growing demand for power. While the consumption of electrical power grew 55% during the period of 1990-1999, the production capacity of the power plants has increased by only 25% for the same time period.

In late 1980s the state-owned power sector in Brazil faced a set of known SOE problems – inefficiency, regulated tariff structure, inefficient financing, overdependency on government funds, and falling investments. Historically, since the investment decisions in the sector were not based on economic performance, power-generation and transmission plants did not have any incentives to become more efficient – investment decisions were made upon personal preferences. In addition, most of the investments were directed to the giants of the industry, while smaller plants were often ignored, and as financial assistance from the government declined, many of the large projects were never finished, and the funds were simply wasted. As the financial burden of the power utilities on the government continued to increase while the government's financial position worsened, the investments in the power industry started to decline rapidly – they stood at $15.4 billion in 1987, then dropped to $8.7 billion by 1990, and were a mere $4.3 billion in 1995. Such a decline in investment caused the power utilities to rely more on their internally-generated funds, and by 1994, while the interest payments on debt reached 66% of the total funds, the power sector was operating with a negative (-44%) net working capital. By 1995, the total debt reached $25 billion, and in some companies it exceeded 25% of total assets (in the case of a company Cerj it was as high as 31.5%). To address the problems the government decided to privatize the energy sector in 1995.

When the decision to privatize came about in 1995, the government faced a lot of criticism, and many doomed the process to fail. Major critics proposed that because of the sector's ownership history (federal as well as state governments), interdependency of the generation, transmission, and distribution services, and a heavy reliance on the hydropower generation it would be impossible to break up the centralized ownership. The privatization started off with smaller power-distribution companies and slowly moved into the power-generation area. By 2002, 20 companies owned by the federal government were privatized, of which only 3 were generating plants and the rest were distribution companies. Proceeds from the sale of the distribution companies reached $16.5 billion and another $1.8 billion was acquired through the sale the 3 generating companies. By 2002 the government had also signed 55 power generation concession contracts worth almost $4 billion with a projected investment value of almost $10 billion.

But the privatization process has been slow. To-date, a majority of power generation, transmission, and distribution services still remain in the hands of the government. By 2002 private sector participation was the highest (70%) in the distribution sector, while it was only 30% in the generation services and a mere 10% in power transmission. The difficulties in privatizing generation companies arise because they are often owned by the state governments, which make a privatization process a political issue between the state and the federal governments. Among the recent failures in attempting to privatize is the state power company Copel, which accounts for about 7% of the total power generation in Brazil. After attempting to sell the company to private hands for two years, the government made the decision not to privatize for reasons that they classified as lack of investor interest. But the lack of investor interest is easily explained – unclear energy rules and regulations. Here lies one of the mistakes that the government of Brazil made. It started to privatize before the institutions necessary for the process to be successful were

put in place. In a situation when the sector is still owned, heavily controlled, and regulated by the government it is hard to generate significant investor interest since the uncertainty and extensive government involvement discourage investors.

Brazil faced an energy crisis in 2001-2002, when prolonged drought caused a decline in power supply and while the demand for power was still growing. As a result, many regions in the country were forced to cut their consumption of electricity and faced rolling blackouts. This, together with increasing energy tariffs, caused many to point fingers at the privatization process and blame it for the sector's problems. Yet, the increase in the energy tariffs that Brazil experienced was something that was bound to happen. For decades, the government regulated tariffs to avoid the abuse of monopoly power by the electric companies. Fixing tariffs at a rate that is lower than the costs caused companies to operate at a loss, which in turn was subsidized by the government. Ideally, when the government can no longer provide the funds and privatization starts to take place, market prices will determine the tariffs, and, as a result, they will rise. In this case, tariffs can be lowered by increasing economic efficiency and by companies becoming more productive. Yet, the government failed to set up a market for power, and the tariffs were regulated by the contracts signed between generation and distribution companies that enforced the lower tariffs based on the old costs. In this situation it is no surprise that the investors did not come in – they had to endure high costs in setting up the new plants, while being forced to compete on the basis of tariffs linked to the lower old costs. Thus, government policies discouraged investors, and the new power supply plants were not built although the demand for electricity continued to rise. With the prolonged drought the generation capacity of the hydropower plants decreased, and with no new plants built the energy crisis was bound to happen.

The government failed to create healthy competition in the energy sector, and private investors did not take advantages of the opportunities because of bad laws and regulations. Lack of political will and government indecisiveness about privatization put the Brazilian power

Lessons from Privatization

- In many countries, introducing competition in sectors where state enterprises previously enjoyed monopolies promotes more efficient operations and better service for consumers. In the long-run, customers are exposed to a better technology and lower prices. In the short-run, privatized companies are often forced to lay off employees, but the negative effects of privatization on employment can be minimized, as seen in the case of Egypt, through early retirement programs and by employing people in the private sector.

- Chile's experience shows that private pension funds can facilitate privatization by strengthening capital markets and giving individual shareholders the opportunity to dispose of their shares while still participating in a program.

- As we see in the case of Zambia, a privatization program will evolve more rapidly if governments do not attempt to restructure their enterprises before they are put up for sale. The private investors will generally do a better job of making the business and financial decisions involved in restructuring. Delays in privatization undermine governmental credibility and public support for privatization. Delays also raise costs for the government, which may create or prolong macroeconomic imbalances.

- Although it is possible for state companies to improve their performance without transferring control (by setting clear commercial objectives, eliminating guaranteed loans, controlling spending, and adequately training managers), they remain prone to some of the practices that contributed to poor operating efficiency and eventual losses – such as special protection and political meddling. Generally, more substantive reforms take place only after SOEs are divested.

- In Czech Republic, vouchers were successful in enabling citizens with no savings and no experience to become instant shareholders. But, while the voucher program can be successful in ensuring the majority's participation in the privatization process, it may fail if the necessary institutions are not in place. In Russia, voucher privatization was unsuccessful in making citizens shareholders, because in an environment of institutional deficit Investment Funds did not become effective investors.

- Privatization, when carried out in an orderly, effective way, can establish credibility, particularly for new governments, among domestic and foreign investors. This effect will both accelerate future privatizations and enhance the success of economic reforms in general.

market in a difficult situation. While the government was rather successful in privatizing the power distribution companies, generation and transmission are still for the most part government-owned. The power problems that the country faced in the 1990s as well as the energy crisis in 2001-2002 were not a result of privatization, but to a certain extent it were a legacy of the government-controlled energy sector. The industry needs reorganization and innovation, and the government should take an active part in fully opening up the sector to private investors, both domestic and foreign.

Telecommunications in Argentina

The privatization of the Argentine telecommunications company, ENTEL, was a major feature of a plan launched in 1990 that signaled a new era in Argentine economic reforms. Through the launch of its privatization program, the government of Carlos Menem hoped to demonstrate its commitment to serious economic reforms and to establish its credibility among domestic and foreign investors, an important ingredient in the success of the reforms.

Prior to its privatization in November 1990, ENTEL controlled 92 percent of the Argentine telecommunications market, including urban networks and international communications. However, outdated technology, combined with limited long-term investment and poor financial planning had hindered continued growth. According to one study, the waiting period for a phone line in 1988 was 21.9 years, and ENTEL was unable to provide almost a quarter of the lines requested. Although the central parts of the network had been refurbished with modern equipment, more than 30 percent of the urban lines were antiquated. As a result, the system often malfunctioned; on average, the problems took 10 days to repair. Rates had been set based on the costs of providing the service, yet had not taken into account capital investments, depreciation, and expansion costs, which meant that ENTEL's revenue base was insufficient to meet its capital needs.

ENTEL was auctioned off through a competitive bidding process designed to attract foreign investors, who were a key element of the privatization strategy because of their ability to provide new technology, management know-how, and investment. The government employed a two-tiered auction system under which bidders had to meet certain financial and technical criteria before their bids were evaluated. Prior to the start of the bidding process, ENTEL was divided into two separate companies, each of which had the rights to provide service in a predetermined region (north and south). The regional division was designed to create competitive market segments. Two consortia, headed by Telefónica Española and STET/France Telecom, won the bidding process and received licenses to operate the regional phone companies. Also, a new long distance provider, Telintar, emerged and a cell phone company was created. A new regulatory agency was formed with revenues from the taxation of the operating companies.

Before the creation of this body, though, the government had incorporated other important regulatory elements into its privatization strategy. During the bidding process, for example, the government had set obligatory performance targets to be monitored by the new agency, National Commission of Telecommunications (CNT). These targets, which included an increase in the number of lines installed per year as well as a reduction in the amount of time needed for repairs, were intended to promote greater efficiency in the operations of the new firms and improve service for ENTEL's customers, which would help maintain political support for the privatization program.

The government sold 60% of the shares of each company to private firms for over $5.2 billion total. The transfer of ownership to private companies enabled the government to transfer the operational risks associated with changes in demand and other factors to the private sector. The privatization of ENTEL produced revenues for the government in three ways. First, the buyers made direct payments for a portion of the sale; second, they acquired (and retired) a portion of Argentina's debt as payment for the balance. (This debt conversion thereby lowered the country's foreign debt burden.) And finally, the government gained tax revenues from the subsequent profits of the newly-privatized companies.

The new private owners were able to employ business performance criteria, such as raising rates to reflect actual costs, in running the new regional companies. New labor contracts gave them greater decision-making power in exchange for modifications in the initial wage structure. Likewise, the workweek was extended from 35 to 40 hours, reducing the amount of paid overtime. Worker benefits and compensation were reduced or adjusted, in some cases to reflect individual productivity. These measures improved financial performance for the new operating companies. The rapid installment of new lines and aggressive investment policies contributed to the improved profitability of the companies.

In 4 years after the privatization, the number of installed lines increased by 62%, increase in network digitalization was almost 7-fold, and total investments surpassed $2 billion in 1994. The number of lines in service per 100 residents that stood at 11.6 in 1990 grew to almost 15 in 1994, and was almost 25 by 2001. Yet, while

Ownership

Many agree that there is no single best type of corporate ownership during the process of privatization and the restructuring of state enterprises, and surveys failed to prove that firms perform better under insider-based ownership rather than outsider based-ownership. The fact of the matter is that type of ownership that should be adopted in the process of corporate restructuring greatly depends on many factors. In some situations, allowing managers and employees (insider-ownership) to govern privatized enterprises is a way to go. In other cases, bringing in outside (non-employee) owners is crucial to a successful privatization program. Successful results have been achieved by adopting either one of the ownership structures in different developing and transition countries. However, in most cases, involvement of foreign investors proved to be the one factor that always contributes to an overall successful transformation process. Foreign owners not only bring much needed financial resources that are vital in any development efforts, but they also apply pressure to build and develop regulatory institutions of governance.

Employee-management ownership is driven by the idea of compensation that is based on performance. The idea is that managers and employees should be interested in the best corporate performance because their rewards directly depend on such performance. The better the organization does the greater compensation is awarded to employees and managers. However, what happened on too many occasions in economies in transition is that inside owners were interested in acquiring personal wealth at the expense of enterprises by illegal means overnight. This can be blamed on many factors – lack of corporate culture, weak mechanisms of control and oversight, absence of financial resources and harsh economic conditions – but the fact remains: too often in developing countries inside owners, after acquiring ownership rights, were involved in activities that only increased their personal wealth, not the wealth of the organization. Enterprises, instead of striving for economic efficiency and growth, only further deteriorated.

To avoid problems of insider ownership, transfer of property rights into the hands of outside investors is often pointed out as a means to privatize. Essentially, introducing outside owners decreases discretionary powers of managers and employees. However, often, in developing countries outside ownership ends up being very dispersed. And while in developed countries it may lead to high management initiative, in developing nations this usually leads to low levels of control and consequently management and employees taking actions that aimed at their personal interests. To address this problem, a structure that includes more concentrated outside owners should be introduced. In fact, studies of some firms and privatization processes in developing countries found that privatized companies performed better under concentrated ownership. This has been implemented in privatization process in Czech Republic through Investment Privatization Funds. Those funds, investing in organizations on behalf of regular citizens, proved to be quite successful. In Russia, however, attempts to establish similar funds failed, because the absence of institutions that govern market activities lead to financial scams by those funds rather than successful investments.

While the type of ownership structure plays a significant role, its significance should not undermine the importance of rules that govern actions of owners – rules of corporate governance. Each ownership structure can perform at its best under the right circumstances and in the right environment. The way ownership structures are established plays an important role: whether they are developed for years or whether they are transferred into the hands of self-interested parties overnight, with little control, and supervision makes a difference between successes and failure.

improvements were evident, compared to experiences of other countries they have been spotty. In fact, according to appraisals of the industry's performance in the early 1990s when restructuring efforts were under way, quantity and quality indicators showed a marked improvement over previous levels, but were still considered mediocre by some standards. For example, the installation of digital switching equipment – important for upgrading the transmission capabilities of the phone network – was well behind that of Mexico and Chile. Also, there were numerous complaints concerning the difficulty in obtaining connections between the two regions. Consumers also complained about the high rates charged by the companies (the cost of international calls per minute was as much as 5 times that of Chile) and in response to these concerns the government explored the possibility of taking a more active regulatory role. In 1991, it made it illegal to change prices through market-driven indexation mechanisms that are used in telecommunication industries. And since there were only 2 firms on the market, the government was able to negotiate a reduction in prices, which resulted in a loss of almost $300 million, but instead the 2 companies received concession contracts for the cell phone industry. Essentially, the government restricted the market to only 2 companies and consequently the industry lacked healthy competition, which is a key if prices are to decline naturally.

Already in a tight fiscal position, the government rushed into privatization hoping that privatization revenues would fix the problems. But in doing so the government did not establish an effective regulatory framework, and,

thus, the process was mired in problems. In fact, because of the inconsistencies and changes in regulations only 3 companies participated during bidding in 1990. Lack of market competition allowed the new companies to strike deals with the government and prevented the prices from falling. But notwithstanding these problems, the successful conclusion of the ENTEL privatization established a great deal of momentum both for the government's privatization program and for its economic reform effort as a whole.

Privatization in China

The process of privatization has been one of the centerpieces of China's efforts to establish a market economy. The beginning of the privatization process in China can be followed back to the late 1970s – early 1980s, when Chinese SOE's were first allowed to retain part of their profits. Now, two decades later, facing increased integration into the global economy and resulting from that process increased international competition, China is still in a great need of reforming its under-performing SOEs.

The process of privatization in China can be better classified as a restructuring, where the government is more interested in curing unhealthy enterprises and keeping the ownership rights in its own hands, rather then adopting the "big bang" approach that some post-communist countries in the Eastern Europe used. And while China has been able to improve the performance of its ailing SOEs in the past decade, they are still facing many problems – corruption, discrimination against foreign investors, over-dependency on the state banks, unclear and false accounting principles, etc.

One of the most important is the problem of labor – government has to keep unprofitable enterprises up and running, because if they fail, the unemployment levels will balloon. Restructuring of the SOEs also brings great financial pressures - SOEs in China carry large debts and often they are able to operate only because of the loans that are being provided by the state banks. If the enterprises are not able to turn profitable, the government will have to write-off those debts, which will put certain financial constraints on its budget. Chinese SOEs face a lack of technological development and innovation, and these issues have emerged as one of the priorities on the "to do" list. Also, the fact that the government, not the managers, effectively controls and runs the organization results in weak managerial incentives that stall the development of enterprises.

The government of China has done a tremendous job in creating an environment for the successful performance of its enterprises. However, what it has to concentrate on now is the successful corporatization of those enterprises – they have to be reformed and turned into profitable corporations. This is where corporate governance comes in. Corporate governance has risen in its importance in China in the recent years since the country faced corruption and financial scandals involving some big and important SOEs. As a result of those scandals, the stock market has been on the decline loosing its value, after reaching its peak in the summer of 2001.

The basis for the corporate environment in China is the Company Law, adopted in 1994, which sets forth the basic principles of establishing and operating modern companies within socialist market economy. Company Law concentrates on describing two types of companies: limited liability and joint stock companies. The law describes a three-tier organizational structure. The main body is the "shareholders general meeting" which is described as a "highest-decision making body" of the organization. Next is the board of directors, which is responsible for making decisions associated with the business activities of the organization and which is directly responsible to the shareholders general meeting. The third body is the board of supervisors, which responsibilities include supervising boards of director and managers and investigating any law violations.

Despite its efforts to privatize and to establish a healthy corporate system, China is still far from establishing well-operating corporations that are a basis for its economic development and growth. The majority of companies are still owned by the state, which appoints its own directors and CEO's. And with the discrimination against diversification of ownership, Chinese enterprises are still insider-controlled, which, as we saw in Eastern Europe and in the Republics of the former Soviet Union, leads to lack of transparency, corruption, backdoor financial dealings, and asset-stripping. What the Chinese government has to do is to change its ownership structure and establish a system of checks and balances, increase the number of independent directors on the boards, and improve information disclosure rules. It should also continue on with the reform of its institutions, particularly its legal and financial sectors.

Czech Republic: Lessons from Vouchers

The former country of Czechoslovakia initiated its privatization program in 1991, at a time when the experience of other countries gave Czech and Slovak policymakers some useful insights that could be applied to the design of their own programs. In particular, they noted that many countries had experienced major delays in disposing of state-owned assets, especially large enterprises. Often, these delays were due to attempts by the state to restruc-

ture the enterprises before those enterprises were made available for privatization.

As a means of avoiding these delays and of creating a framework for the rapid privatization of large state enterprises, the authorities created a voucher-based mass privatization system. The reason for employing voucher privatization was, according to some, the lack of cash in the economy. Distributing free vouchers was the only way to involve common citizens who otherwise were not able to acquire shares in the privatization process. The idea was that each citizen would receive vouchers worth 1000 points of investment money for a registration fee of 1000 Koruny (about 25 percent of the average monthly wage). Citizens could then use those vouchers to bid for the shares of all companies that were being privatized under this method. The government selected several thousand large enterprises for voucher privatization during the first wave, which would consist of as many rounds as necessary to dispose of the shares.

It is important to keep in mind that a) a variety of methods, including more traditional ones (e.g., public auctions), were available to privatize state firms; and b) the privatization system permitted anyone interested in purchasing an SOE or some of its assets to present a proposal for review by the federal Ministry of Privatization. The proposed projects could incorporate any privatization technique. Most projects approved in the initial stages of the privatization program were for voucher privatization, because the inauguration of a viable voucher system was an important priority for the federal government.

The priority attached to the voucher system stemmed from its many advantages in the eyes of the policymakers. First, vouchers enabled the citizens with no savings to purchase shares and no experience in evaluating stocks as investment opportunities to become instant shareholders and instant participants in the country's embryonic market economy. The system was also intended to maximize the number of citizens who could participate in the purchase of state firms, incorporating a sense of fairness into the process, which would enhance support for privatization among the general population.

Common citizens faced a real problem of informa-

Czech Success Story: SKODA

SKODA, a Czech car manufacturer, was known for producing cars that directly reflected the name of the company that in Czech means "shame" or "pity". Not only the cars the company made were of low quality and bleak design, but with the collapse of the Soviet Union its car sales dramatically declined as foreign automakers were given more access to the market. Its factories were run down, suppliers – unreliable, and workers – disappointed. Today, SKODA is one of the model automakers in Europe and is one of the best performing companies in the country, producing almost 500,000 cars a year and selling them in almost 80 markets worldwide. Responsible for such success is the privatization program as a result of which SKODA was sold to the German auto giant Volkswagen for $650 million. The sale was done in several rounds – in 1991 the German automaker purchased 31% of the company and in subsequent years increased its ownership to 70%. More importantly, while the government retained 30% stake, it guaranteed Volkswagen that it would not interfere in the management of the company. Following the privatization of SKODA in 1991 Volkswagen invested over $6 billion in the company, a majority of which went towards modernizing the facilities and improving the production process. And as the company became more stable and profitable the government sold its 30% stake.

One of the major obstacles SKODA had to overcome to crack international markets was the poor quality of local supplies. The company took an innovative two-step approach to the problem. First, with the help of the VW Group's worldwide connections, it has helped engineer some 40 joint ventures between its local suppliers and leading US and Western European parts manufacturers such as Johnson Controls and Siemens. Second, it has brought some of its suppliers in-house, renting them space within its own facilities. This way it can keep a close eye on the quality of parts going into its cars and also save on transportation costs of heavy items such as seats, dashboards, etc. The quality of some of the suppliers has gotten so good that they are now selling to other leading automakers in Europe, generating additional export earnings for the Czech Republic.

Dealing with a bloated labor force was another difficult issue in the transformation of SKODA. The company had strong unions, which previously resisted worker cutbacks despite the company's bleak prospects after the breakup of the Soviet bloc. However, it has won labor over by instituting many practices common in Western European companies. These included rewarding workers for providing innovative ideas, using teams to produce the vehicles and solve problems, and offering the workers free training and staff-development courses. SKODA, for instance, was the first company in the Czech Republic to institute a two-year training program in economics and management.

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tion. It was troublesome to determine true value of enterprises. While the Ministry of Privatization did publish book values for several thousand enterprises, many were inclined to believe that those values would change upon introduction of those enterprises to the market. Opponents of the voucher privatization also argued that the process would lead to dispersed ownership, and in the environment where corporate institutions were rather weak this would lead to corrupt activities. Recognizing these problems Czech government turned to the Investment Privatization Funds.

Investment Privatization Funds (IPFs) operated with vouchers collected from citizens who preferred to let the IPFs invest their vouchers in available companies instead of doing it themselves. Some IPFs promised spectacular returns for investors. Voucher-holders were given a specific period, the so-called "zero wave," to designate their vouchers to one of the IPFs. At the end of this period, roughly 5.8 million citizens, or about two-thirds of the voucher-holders, had designated all of their voucher points to one of the IPFs, while another 420,000 allotted a share of their points to these funds.

IPFs were structured as joint-stock companies, with citizens who assigned their vouchers to an IPF becoming stockholders in it. They had the right to participate in decisions concerning the management of the corporation and the distribution of its receipts. The founder of an IPF was usually an investment fund, a bank, or an insurance company. IPFs functioned as legitimate investment entities and had to provide basic information such as investment strategy and ownership structure. More than 400 IPFs participated in the program and these investment funds turned out to be a major player in privatization process, receiving as much as 70% of the vouchers used in privatization process.

The privatization process was conducted under three programs. The first was the process of restitution, which involved transferring ownership rights into the hands of the original owners of businesses, before communist regime. The second program was small-scale privatization where about 100,000 small companies were successfully privatized. This set the stage for the third program – mass privatization, which began in 1991 and involved roughly 3,000 state enterprises.

The first wave of mass privatization, during which almost a thousand enterprises participated in the process, was conducted in five rounds. In each round, bidders used their voucher points to bid for the available shares of privatizing firms. Share prices were set by the Ministry of Privatization and adjusted in subsequent rounds based on the demand for shares at the original price. Thus, for shares where demand exceeded supply, the prices were raised prior to the next round, while the prices of shares with excess supply were lowered. Unused voucher points were returned to the bidders for use in subsequent rounds. The price adjustment mechanism established in each round ensured that the valuation of corporate shares was achieved through a market-based, supply-and-demand mechanism. In the first wave of mass privatization, the Czech government privatized over 2,400 firms worth more than $7 billion and over 40% of those firms were privatized through the voucher program. The second wave, where over 800 enterprises participated, was conducted much in the same way.

Czech endeavors with voucher privatization have been pointed out as both a disastrous experience and a model for future privatization efforts. Some consider the way the voucher process was implemented to be successful, since it allowed for share prices to adjust through the process by the means of market mechanisms. By using IPFs and thus involving the majority of the population in the privatization process, the government created millions of shareholders, which was a driving force behind a broad-based support for the program itself. Involving IPFs in privatization allowed for greater success of the program not only because they were an effective participatory mechanism for the citizens. Since IPFs were legitimate business entities, they were interested in successful, long-term performance of the enterprises where they acquired ownership.

The use of IPFs has also resulted in some problems. A majority of the funds were managed and operated by the banks, which were not yet privatized and therefore were controlled by the government. As a result, the state banks tended to extend credit or otherwise create favorable financial climate for those companies in which bank-run IPFs acquired ownership. These lending practices were a disincentive for restructuring and they also led to profiteering by managers who would acquire credits through the "friendly" banks and then transfer money into their own accounts. Such over-lending by the state banks turned out to be a problem when they were privatized later in the mid-late 1990s. They acquired so much outstanding debt, which could not be repaid, that the government received very little in privatization proceeds from the sale of the banks.

Lack of regulations on securities transactions and absence of mechanisms governing or overseeing the activities of IPFs resulted in another problem. After the mass privatization process concluded in the mid 1990s, IPFs started to trade ownership in different companies to either diversify their portfolios to minimize risk or to concentrate their

ownership in certain industries. With a securities system that did not function, swaps of shares between IPFs were often done behind closed doors and by legally questionable means. But despite the difficulties, Czech privatization is a lesson for those who want fast privatization with maximum citizen participation. The voucher program was successful in allocating ownership quickly and the Czech policies did not fix the prices of shares rather allowing market forces to determine their value. It is also a perfect example of how lack of corporate governance mechanisms and weak regulations can undermine the results of privatization efforts.

Conclusions

In tracing the evolution of privatization and examining the approaches and results of some privatization programs, it is essential to keep in mind that privatization is fundamentally a political transformation, that is, a change in the government's role in the economy and in society as a whole. Because of the magnitude of this transformation, it can be accomplished only with great difficulty, something that is characteristic of any fundamental change.

The debate over privatization is fundamentally a political debate. After all, in democracies old and new, it is the citizens who must decide what functions they want the government to perform. When the government cuts back, individuals and groups who used connections to obtain government support in one form or another will use those same connections to impede changes perceived as injurious to their interests. For this reason, privatization requires a great deal of political courage. Especially in new and fragile democracies, such courage is hard to come by. This suggests that privatization techniques that cultivate and maximize political support for the process will have the best chance for success. Even with such techniques, however, success comes slowly, with economic hardship often the most immediate and noticeable result.

The rationale behind privatization is simple – it is good because it revives companies, creates healthy competition, improves market productivity and quality, and results in lower prices as well as better choices. Yet, governments in some developing countries have continuously failed in their privatization efforts, and many citizens in those countries have yet to see the benefits of privatization. The reasons vary, but, generally, responsible for privatization failures are lack of a strong regulatory base that supports privatization, weak governance structures that undermine the integrity of the process, and politicization of privatization. While empirical studies show that performance of SOEs is much lower than that of privatized companies, the governments are often unwilling to give up control because controlling strategically important companies and industries allows them to stay in power. Also, it is important to keep in mind that for privatization to be effective, the conditions necessary to support a thriving private sector must be in place. This is why privatization does not succeed in countries where it is not carried out in conjunction with reforms designed to create or strengthen market-based economies.

However, many countries have succeeded in privatization. Such success stories show that privatization, when carried out in an orderly, effective way, benefits regular citizens and can establish credibility, particularly for new governments, among domestic and foreign investors. This effect both accelerates future privatization and enhances the success of economic reforms in general. In the end, governments face a difficult balancing act, often having to impose short-term pain as the price of long-term gain. For citizens looking for a better future, the promise of long-term gain is a rich one indeed. Privatization offers a promise of a long-term prosperity, along with the chance for citizens to become owners and investors in former state enterprises and thereby assume a greater control over their economic destinies.

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