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Privatization: Misconceptions, Glib Answers, and Lessons

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My first exposure to privatization was leading the first World Bank/International Finance Corporation privatization mission to Peru in 1982. At that time no enterprises were sold, but today privatization seems to be a message whose time has come. Recently, President Fujimori announced the sale of over 30 state enterprises.

Since that first mission, I have worked on or analyzed public enterprise reform and privatization in a lot of countries: Brazil, Mexico, Chile, Ecuador, Argentina, India, Thailand, Korea, Tanzania, Malawi, Ghana, Czechoslovakia, and Russia, for example. Today I would like to give you a tour of the horizon on privatization, showing you how things have changed. Then I want to talk about some common misconceptions concerning privatization, about how hard it is and also about how easy it is. I will then conclude with a word on the lessons of experience and the role of the World Bank.

Once we used to say that the rhetoric on privatization far exceeded the action, but now that phrase is no longer true. Since the early 1980s, almost 7,000 enterprises have been sold worldwide; over half of these in the former East Germany. Lest you think it is only East Germany that is privatizing, however, bear in mind that developing countries have sold over 2,000 enterprises.

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Many observers also used to say that most of the sales would be of small enterprises that would not make a major difference in the size of the state-owned sector, but that too is no longer true. Some countries, such as Chile, Jamaica, Guinea, and Mexico, have sold a large number of enterprises and captured proceeds that are sizeable in comparison to their economies.

It also used to be true that developing countries would not sell their so-called "strategic" enterprises. Governments wanted to keep the "commanding heights" and infrastructure companies in public hands. This too no longer holds—large enterprises are being sold in sectors such as banking, telecommunication, power, airlines, steel and mining. Privatization is clearly beginning to make a difference in the face of the world. But just as we must rethink what we used to assume about the extent and importance of privatization, we must also correct some misconceptions about it.

Common Misconceptions

Three common misconceptions make privatization seem much harder to do than it is:

1. Governments want to sell the dogs; buyers want the stars.

The first point is often true, although becoming less so. More and more governments are willing to sell the "stars." For example, the year when Chile sold Chilgener (an electricity-generating company), it made Chilean pesos 3 billion profit. This was not a dog, but a very well run company. Profits doubled the year after sale and continued to soar after that. In fact, Chile sold many "stars" in order to lock in the efficiency gains and give its people a stake in the performance of these companies.

Furthermore, it is wrong to assume that governments are always eager to sell their "dogs." I know of one developing country that had letters of intent from three private sector purchasers to buy and reopen three tanneries that had been shut down for years. The government never negotiated further with the potential buyers because privatization was considered politically unacceptable. If privatization is not accepted, the condition of the enterprise, good or bad, makes no difference.

And what about the second point, which implies that the private sector only wants to skim the cream? This too is not true. It is a little known fact that most privatizations in least developed countries have been achieved through liquidation. Most of the sales the International Finance Corporation (IFC) has done—which included some 20 investments in privatized companies—have been money-losing or closed companies. The private sector takes into account the deal—the price and extent of its control—and the prospects for the sector and market. Private buyers may see a way to make a closed company profitable and put idle assets to productive use.

Thus, in selecting companies for sale, sellers should consider two things: one, where investor interest lies, which may have as much to do with the prospect of the sector as whether the company has made losses; and secondly, which companies need new investments or efficiency improvements.

2. Labor always loses.

One obstacle to privatization is opposition from labor —or government fear of potential labor opposition. The assumption is that workers will lose in any deal, yet this is not necessarily true.

In a study we did of the effects on economic welfare of the sale of twelve companies in the U.K., Malaysia, Mexico and Chile, labor had net gains in all cases. That means that laid-off workers were compensated and retained workers were paid enough in salaries and shares to offset the loss of jobs. In three cases, in fact, substantial gains resulted. Why? Private companies, far from laying people off, may expand and hire even more workers. An example is the Mexican autoparts industry where privatized companies increased employment by 30%.

Furthermore, private working conditions may be better than those at public enterprises. For example, workers at the Malaysia Port Kelang Container Terminal opted for insecure employment with the private buyer over the choice of secure employment at the Port Authority or generous severance pay. Why? Because the private company offered a chance at merit pay if workers met productivity targets.

And, severance pay can also help compensate for job loss. In fact, it often exceeds the legal minimum (as was the case in Pakistan, where severance payments have been as much as five times the legal limit). Of course it is true that this is not always the case and that privatization can lead to loss of jobs. The layoffs of redundant workers are not a feature of privatization per se, but would be part of any state-owned enterprise reform program, regardless of ownership.

Nevertheless, it is important to anticipate such problems and help socially vulnerable groups through the transition by providing severance pay, unemployment compensation, assistance in finding new jobs, retraining, and the like. Conditions can be created so that labor is not the loser, or to help those who do lose out in the short run to become productive workers in the longer term.

3. You must first develop the capital market to privatize.

Most privatizations have not relied on the stock market: Canada has only sold two enterprises that way; Chile has sold 14; France 14; Jamaica 3; Nigeria 16; and the U.K. 14. That in comparison to a worldwide total of about 7,000 companies sold is very few.

There is no doubt that privatization is easier with a capital market, but the absence of a stock market is not necessarily a stumbling block. Selling stocks widely can help reduce political opposition, but there are many reasons why governments may prefer not to sell shares. And there are alternative ways to spread ownership. For example, governments can give shares away, as in Eastern Europe; governments can auction companies; and governments can negotiate with several potential buyers.

Even where there is only one buyer, the threat of competition may make the process fairer. The price offered for a steel mill in a Latin American country went from about $5 million to $33 million—well above the minimum asking price—thanks just to the threat of competition. Of course, competition is to be preferred if you can get it.

Two Glib Answers

I spoke of some misconceptions that make privatization seem harder than it is, now let me talk about some glib answers that make privatization seem easier than it is.

1. Regulation.

Regulation is crucial for success, but it is very hard to get it right. Bradburd and Ross looked at regulation and deregulation in developed countries and tried to pinpoint the lessons for least developed countries. They found three lessons in United States regulation: regulation of imperfect competition was excessive; regulatory systems were prone to misdirection, if not capture; and many regulatory efforts were so inefficient as to lead to regulatory failure, that is, the regulatory outcome was worse than laissez faire.

If regulation is so problem-ridden in the United States, how much more likely are problems in countries where institutions are weak and skills are less available? There is a tendency to underestimate the complexities of doing regulation right.

Consider the choices that Venezuela has had to make in privatizing its telecommunication company:

Presider Robert Mc Phail, partner, DRT International, and Mary Shirley..

Photos By Larry Lettera.

1. Pricing scheme: They have chosen a price cap scheme—the rate of inflation less a productivity factor—which is generally considered to induce greater efficiency than the rate of return regulation.

2. Terms of the concession: It has granted the new operator a nine-year monopoly on basic local and long distance national and international services, in an effort to provide a balance between competition and financial viability for the privatized company. The expectation is that the company will fund an aggressive expansion program.

3. Private networks: The government has authorized 20 private networks and has at least that many proposals pending.

4. Other services: The government must also decide about value added services—services which use the basic network to deliver additional, different, or restructured information to a user—cellular services, equipment production, and so on.

These decisions are not easy; there is no simple answer applicable to all situations; and they make the privatization of large monopolies in nontradeable sectors tricky. Things can go wrong. The recent study we have undertaken of the effects of privatization on welfare found that in one telecommunication sale in Latin America (not Venezuela), the welfare of consumers after the sale went down because the regulatory framework allowed the company to exploit consumers.

Yet the privatization of electricity and telecommunication in Chile did not reduce consumer welfare; it went up. In fact, in the telecom deal in Chile everyone was better off—consumers, workers, buyers, and government—because they had the right regulatory framework. Regulation is crucial and it can be done right.

2. Valuation.

Consultants abound who are ready to assess the value of assets using price earnings; discounted cash flow; asset value; and comparators. But there are serious problems with this. For one, incomplete or nonexisting data; one telecommunication company we know of was sold with no balance sheet for the last year. Secondly, the market is volatile. In one example, the bids on a Mexican airline went from 0 to 7 after Mexico signed a debt reduction agreement. And lastly, a flawed market. The Philippines and Jamaica offered high yield, low risk, tax free government bonds that competed with their state enterprises and drove buyer interest away.

There are many instances of wrong valuation, but to give just one, a Costa Rican aluminum mill (Alumasa) was first valued at a book value of $52 million; it was then valued with a comparable mill in Venezuela at $8 million; and it eventually sold for $4 million. Wrong valuations can be a stumbling block: an African shipyard was valued at $6.2 million, but its profits were only $3,600. Such a company is unlikely to sell at that high price. Compare this with the Treuhand which sold thousands of enterprises for the symbolic price of 1 Deutsche mark. They aim to put moribund assets to productive use; their view is we are "not selling a company, but buying management and technology." Valuation should set a fair bottom line, not too high and not too low.

> "Privatization causes an increase in investment and innovation, which is partly because the deals themselves are designed to encourage investment. Moreover, private stake holders have a strong incentive to see unfolding opportunity more readily and seize it more aggressively than public bureaucrats do. Very few public enterprise managers are rewarded for taking risks, even risks that pay off, while the penalty for mistakes is high."

One Hard Lesson of Experience

There are many reasons *why* governments may want to privatize:

1. To increase public resources.

If you price it properly, the amount you get for a public enterprise should be equal to the discounted net present value of any future income the enterprise would have given the government, plus its scrap value. Selling an enterprise now means that you may give up some revenues in the future, although it is quite possible that the taxes from the private company will exceed the resources the public firm would have generated. So in a theoretical sense, the resources argument is an illusion. Indeed, an overemphasis on generating resources can lead to a sacrifice of efficiency. The buyer might pay more for a cozy monopoly that earns rent than a competitive firm that may or may not make profits.

2. To reduce debt.

The Argentine sale of their telecommunication company reduced the foreign debt by $5 billion and that was important. But it should not be forgotten that debt/equity swaps give the buyer a discount on the face value of the asset. Government might be just as well off if it sold the enterprise and used the proceeds to buy back the debt—something Mexico plans to do with the $15 billion they have raised through privatization.

Here again, if the government focuses on maximizing the proceeds from the sale or the amount of debt retired and loses sight of the efficiency effect, the impact on the economy could be very adverse.

3. To develop capital markets and disburse ownership.

This, again, should not be the primary objective. Although Chile used privatization successfully for this purpose, it can lead to underpricing of shares; gouging of naive shareholders by the sale of poorly performing firms about which the public knows little; and lack of a core shareholder to improve the management of a company. Widely disbursed ownership can also be hard to sustain.

Now let's discuss why governments *should* privatize.

1. To improve the use of public resources.

The Finance Minister of Mexico, Pedro Aspe, uses a very telling example to illustrate how privatization can improve the use of public resources. The amount that the Mexican government paid to upgrade the fleet of its national airline could have been used to pave over half of the country's unpaved roads, yet only about 2% of the population of Mexico has ever flown. Or consider that the accumulated losses of Mexico's large public steel mill now exceed $10 billion; with a fraction of that amount the state could bring potable water, sewerage, hospitals, and education to the poor in every community in southeastern Mexico. Public enterprises divert public money and—an equally scarce resource—public management skills from high priority uses. Privatization frees those resources for other, more important tasks such as education, health, and nutrition.

2. To improve operating efficiency.

For example, after privatization, a Latin American telephone company saved $10 million in wages paid out just by asking its workers to show a picture ID when they came to pick up their pay check, and a Chilean company saved $88,000 a year by reducing the theft of electricity. This story can be repeated again and again. Even more telling, the in-depth study we are doing of the efficiency effects of privatization in 12 company cases shows consistent improvements in net economic welfare in 11 of the 12 companies studied.

3. To improve dynamic efficiency.

The Chilean telephone company, for example, increased the number of phone lines by 72% in the three years after it was sold, and the newly privatized Mexican phone company, Telmex, is laying down 8,400 miles of fiber-optic cable to link Mexico's 56 largest cities.

Our research shows that privatization causes an increase in investment and innovation, which is partly because the deals themselves are designed to encourage investment—Telmex pays 10% taxes if it invests; 29% if it doesn't. Moreover, private stake holders have a strong incentive to see unfolding opportunity more readily and seize it more aggressively than public bureaucrats do. Very few public enterprise managers are rewarded for taking risks, even risks that pay off, while the penalty for mistakes is high.

The private sector is also freed from the political constraints that make it hard for public companies to raise the capital for new investment.

The Role of the World Bank

So what is the role of the World Bank? The Bank has approved over 180 projects in 67 countries which support privatization, while the IFC has done 50 investments or advisory projects to help governments privatize. Our role is to help countries develop a market-friendly policy framework, so that privatization expands competition and increases efficiency; we also help prepare for privatization by developing a strategy and creating the necessary institutional and legal apparatus; we finance the necessary expertise, such as investment banks, law firms, and consulting firms, to prepare and conclude deals; we develop a social safety net to help ease the transition and protect vulnerable groups; and lastly, we develop a regulatory framework so that after privatization consumer welfare and the environment are protected.

In conclusion, then, privatization is neither as hard nor as easy as it seems and three objectives should be paramount: efficiency in the use of public funds; efficiency in the operation of enterprises; and efficiency in new investment and innovation.

The World Bank Group tries to make sure that countries maximize the benefits and minimize the costs of privatization by creating the right environment, building the right framework, and doing the right sort of deals.■

Questions and Answers

Q You talked about cases where governments should privatize and reasons why they want to. Could I ask you to comment on cases where they should not privatize and in particular could you comment on shock therapy, which has been widely advocated, particularly in the CIS countries. A lot of people are talking about the human cost involved in that process and I'm wondering how you view it.

A There is another reason for privatizing that I did not mention before. The countries of Eastern Europe and the CIS have a sense that they need to privatize in order to have a market economy. I personally believe that they're right in that sense. One problem that many of these countries face is that they don't have private owners who will react to market prices. So they are asking themselves how they can have a market if they don't have market players. I think it's hard to argue with that reasoning. Then the question becomes how fast or slow to privatize; my sense is that it's very difficult to say now. They're all experimenting with these very large sales. There is no doubt that the Treuhand has successfully sold thousands of enterprises in East Germany in a very short period of time, but that is the only instance where that has been done. Can that be replicated in a lot of other countries? I confess I'm not sure myself. I can well understand, though, the rationale for using mass privatization schemes. These countries are trying to transform their entire economy; without mass privatization the transformation may take so long that the process becomes halted entirely.

Q Is there a trend where the World Bank is going to offer a lot of money to private enterprises?

A We have an arm of the Bank Group, the International Finance Corporation, that lends directly to the private sector. The Bank itself, under its articles of agreement, has to lend with a government guarantee. Although we have on very few occasions lent directly to private enterprises, such as the Tata Group in India, in the past, there have been questions in people's minds about whether you're achieving the kind of privatization you want if you're lending to a private enterprise with a government guarantee. There is also, in my own mind, some doubt about whether it is a good idea to single out privatized companies for special treatment compared to the private sector in general. In all of the market economies we know it was not privatization but new private entry that formed the private sector. You wouldn't want to discriminate against that private entry; against those companies that are formed, not through privatization, but by the workings of the market. Therefore, most bank lending to the private sector is through financial intermediaries, through banks and other kinds of financial institutions, which can then lend to privatized or new private firms on an equal basis and without giving private borrowers a government guarantee.

Q To what extent is the World Bank increasing the use of employee stock ownership plans in the privatization process?

A Research shows that you get more productivity gains by giving people bonuses that are directly related to what they achieve at work than by giving them share ownership. That makes sense; the carrot is right there in front of them if it's a bonus for their work efforts. So the idea that share ownership increases productivity is not really a proven one, although there were very good productivity gains after the National Freight Corporation in the U.K. was sold to its workers. Share ownership is an important and useful tool for winning workers over to the idea of privatization. It can also be very useful for getting workers more involved in the company and more interested in the company's future, and for that reason it's being advocated in a lot of the CIS countries. The tricky thing is to make sure that the workers' shares don't become too large. There have been instances where the workers ended up owning the single largest share in the company and had a seat on the board, and then used their power base to increase their wages above what the company could financially afford. In those cases worker ownership created perverse incentives. On the other hand, worker and pension fund share ownership in Chile has been very effective, and helped to create and expand the Chilean stock market. So, a certain amount of worker ownership seems to be a very valuable and important part of privatization, but it has to be done in moderation.

Q I was wondering how important you think it is that constitutional guarantees be implemented, concerning property rights. That is, guarantees that the government could not reseize any companies it sold and that if it did it would have to pay full fair market price for those companies.

A I think it's very important, but obviously actions speak louder than words. One of the critical factors for many investors is going to be whether government backs up its legal prohibitions against seizure with behavior that shows that it's not going to try to seize assets. There are many ways of seizing assets; you don't just have to nationalize, you can take the profits away through taxation that's so high that it doesn't allow profitability. Many countries, like Russia, are opting for leases rather than selling real estate. These are sometimes fairly short-term leases, which may not necessarily deter interest in buying into a company and leasing its land as long as the returns are high, and investors have a sense that their investment is protected. Nevertheless, some kind of constitutional guarantee along with a well functioning legal system—so that contracts are honored and owners can appeal what seems to be arbitrary behavior by governments—is very important and it's something that the Bank and others are trying to help governments develop.

Q Have you specifically tracked the results of the success or failure of those companies that you have been involved with privatizing?

A Yes, we went to great lengths, in fact, to measure results in twelve cases, not all of which we were directly involved in. One of the things that has disturbed me about the literature on privatization is that most of the evidence pro and con is fairly anecdotal,

Archie Mc Arthur (foreground), Canadian Consulate General; Carlos Fligler (center), Delta Capital Corporation; and John Friedler, Techint, Inc.

and I wanted to have a very clear measure of outcomes. That means, looking not just at profitability, but also at real economic welfare and measuring who won and who lost in detail. We have just completed that research with a group of researchers from Boston University led by Professor Leroy Jones. We expected to see mixed results. We thought we had picked companies and countries that would give us that: Mexico, Chile, Malaysia and we used the U.K. as a control group. The surprising thing to us was that in 11 of the 12 cases welfare improved; quite substantially in many of them. And that was not what we expected. In fact we thought the research would be more interesting if privatization did not always work well, so that we could say, here is how you make it work, and here is how you do it wrong. So it surprised us. I must add that the researchers were very conservative in their assumptions. If they couldn't attribute improvements very clearly to the privatization, even though the gains occurred during the time after privatization, the researchers said, "Well, the public company would have improved that way, too." Yet despite these very conservative estimates, privatization led to good results. We now plan to add cases from some least developed countries, because I'm not sure we would have the same outcome if we had included cases in an institutionally weak country that doesn't have the same capability to regulate of, say, a Chile or a Mexico.

Q How many of those cases really exhibited what you might call real competition within the industry, as opposed to being dealt with through straight regulation? Were you able to evaluate the free market versus government regulation in the outcome?

A We selected the companies to represent a mix, so half are producing nontradeables—such as telecom and electricity—while the other half are producing tradeables. We investigated the Malaysian lottery, for example; three years after it was sold it tripled the amount of revenues that it paid the government compared to when it was public. In looking at who won or lost, we also included competitors. There are cases in privatization where the competitor also won, even though the buyer won as well. We all know that you can get a lot of gains by privatizing competitive companies, that's very evident, but what was interesting to us was to see how you can get gains by privatizing monopolies as well. That was another of the unexpected outcomes of this research.

Q I wonder if you could tell us a little bit about how the Bank achieves the goals it has in privatization; in other words, what are your carrots and sticks?

A We make adjustment loans which have as a condition of disbursement satisfactory performance on agreed policy reforms. These loans are meant to help governments finance the balance of payments during the transition period of adjustment, and privatization is often a part of that adjustment. I mentioned that we support a package of reforms, not merely privatization in isolation, to open up the market and increase competition. This support is usually through adjustment lending. We also have technical assistance loans which finance the assistance of lawyers, investment bankers, and consultants. The International Finance Corporation has a group that gives advice directly on privatization and works with governments to help privatize companies. IFC also makes equity investments directly into privatized firms. Often when the IFC is involved, a lot of other investors will get involved because, although it does not guarantee the investment, it gives investors comfort that the government will not confiscate profits. We also have MIGA, the Multilateral Investment Guaranty Agency, another sister organization in the Bank Group, which guarantees investments that may be associated with privatization. It is a new agency which guarantees equity investments and so far it has done three that were associated with privatization.

Masahiko Imazato (left), Japan Development Bank, and Jack Heberle, AFL-CIO.

Q I have the impression that in some countries privatization has become something of a buzzword, a kind of magic wand to fix economies which really are in deep trouble in a broad way and that the political factors, as you mentioned, are so closely interrelated to the economic factors that it is impossible to divide them. Could you take the various factors you've been talking about and apply them to your experience in one country?

A Mexico is a good example of the importance of getting the policy environment right first. The reforms Mexico implemented prior to the privatization of large companies were critical for successful privatization. These policy reforms had to be implemented before privatization could achieve the kind of efficiency gains that I've been talking about today. The interest of investors in major privatizations is dependent on their sense of government commitment to do more than just sell companies, but to create the kind of market-friendly environment that companies need in order to operate profitably. Privatization contributes to a kind of snowballing effect, so that, once you get some reforms underway, privatization gives investors a sense that government is going to move forward with reforms. Many investors feel that, if you can change tariffs with a stroke of a pen, you can easily change them back again or if you can undo this price decree you can quickly enact it again. But the sale of state enterprises is harder to undo, it's much more visible. So many investors feel that when sales occur government is showing a commitment to other reforms. Privatization works best when it goes along with other macroeconomic reforms, and it is also part and parcel of making those other reforms work effectively. I think that the political factors, the underlying rivalries that might be responsible for privatization to begin with, get submerged in the general movement of the economy when you privatize. Privatization creates new stake holders in the new environment; a pyramiding of interests in moving forward towards a more open, liberal economy.

Q In countries where there hasn't been much of a private sector, what kinds of efforts do you either encourage or help finance to create programs to motivate employers and society?

A One part of our Division works on what we call Private Sector Development which is very much in line with what you are describing. The Bank has been actively involved in trying first to create the right environment, what we call an enabling environment, for private sector development. Often the private sector is underdeveloped in part because there are so many policies that work against private entrepreneurs, particularly small ones: they have to register, there's a lot of red tape, there are a lot of prohibitions. In many countries the way the tax is administered is very onerous and the new entrepreneur has to spend a lot of his time just dealing with many different tax forms and regulations. We are trying to pinpoint these issues. We do a lot of surveys of entrepreneurs to try to determine the constraints to new private entry, especially the many constraints that can be done away with quite easily. Developing business-like attitudes, on the other hand, can be more difficult. We finance training and we also give training in developing countries through our Economic Development Institute. We also work through financial intermediaries to make lines of credit available to new investors. We also try to open up public procurement to smaller enterprises; often the public contracts are awarded only to very large firms or to public enterprises. For instance, in some countries textbook production has almost always been a public monopoly. When we give education loans we try to encourage textbook production to be competitive and open so that different producers can bid.

Q Will privatization, which is supposed to create economic wealth, lead to faster economic growth worldwide over the next five or ten years?

A Privatization is not enough, in and of itself, to do that; it has to go along with a lot of other reforms. It seems to me that privatization, as part of such a package of reforms, has a lot of promise to stimulate growth in countries that haven't been growing, and that's extraordinarily important for those countries. It will also enable governments to use freed resources for the social infrastructure, nutrition, health, and education. This too, over the long term, will contribute to future growth in these economies. But of course, domestic policies of developing countries are not the only factors which determine whether there is a worldwide upsurge in growth. Many of these countries are small; they are not going to be the main determinants of future growth worldwide. What happens in the OECD countries will be far more important. I think privatization bodes well for developing countries, but it is not the only factor at work in the world economic situation.

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