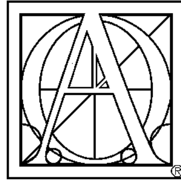

# OXFORD ANALYTICA

# EXPLORATION OF THE IMPACT OF PRIVATISATION: OVERVIEW AND CASE STUDIES

A Study

Prepared For

**EC/DFID**

SECOND DRAFT

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# EXECUTIVE SUMMARY

## PRIVATISATION OVERVIEW

### Privatisation Scale

Although the 1980s saw significant asset sales in some developed and developing countries, it was only in the 1990s that privatisation took off. Global proceeds between 1990 and 1999 were 850 billion dollars, with developing and transition economies accounting for approximately 30% of privatisation revenues.

### Privatisation Justification

There are three inter-related arguments used by national governments to justify privatisation: economic rationale related primarily to business efficiency; pragmatic reasons such as reducing budget deficits; and pressure from international agencies, who themselves are drawing on the economic rationale for the reduction of state ownership.

### The Impact of Privatisation

The literature examines the impact of privatisation at both micro and macroeconomic levels:

**1. Profitability.** Surveys of profitability in privatised firms in developing and transition countries are generally positive, but the best improvements are in the richer countries.

**2. Efficiency.** Most of the analysis on efficiency and productivity has focused on comparisons between public and private firms, the latter embracing both already private and privatised firms. Studies generally point to an improvement in performance, but the developed country analysis shows that the bulk of efficiency improvements in privatised companies took place before the act of privatisation.

**3. Fiscal effects.** Survey data shows a substantial injection of revenue from privatisation, and government transfers to the privatised firms were also much lower than they had been when the firms were under public ownership. However, it is difficult to disentangle effects on budget deficit levels from other reforms taking place.

**4. Growth effects.** The impact of privatisation on overall growth is also hard to isolate: privatisation does not take place in a vacuum and for the most part countries engaged in the policy are also committed to a range of other structural reforms also likely to have a beneficial impact upon growth. Overall, however, there does appear to be a strong correlation between privatisation and improved growth.

**5. Market development.** It has been shown that privatisation has contributed significantly to the development of capital markets -- privatised firms are often among the most valuable companies in local stock markets. It is less clear how far these effects spread beyond the privatised firm itself, particularly in developing countries. Overall, privatisation is most effective when preceded by stock market and trade liberalisation.

**6. Consumers.** Consumer gains from privatisation largely depend on the nature of the firm being sold. Where the firms are operating in open and competitive markets, consumers will benefit from increased choice, innovation, quality of service and lower prices. Where privatisation takes place in

infrastructure/monopoly services -- much of privatisation has focused on such activities -- consumer gains are not automatic and will depend on regulation.

**7. Employment and equity.** Privatisation programmes have done more to enhance efficiency than equity -- at least initially, and on average have worsened wealth distribution and income distribution. There remains a widespread perception that the overall impact of privatisation upon labour is negative.

**'Externality' effects.** Externality effects are felt at a number of levels:

- While there is little research on the question of Research and Development (R&D), observations in developed countries show that privatised firms tend to reduce their commitments in this regard.

- Many critics of privatisation, particularly as it affects developing countries, have argued that in the trade-off between a clean environment and private profit, the latter prevails and that private investors will take advantage of poor regulation to engage in production that is polluting. However, proponents argue that this criticism underestimates both the limitations of pre-privatisation structures to promote or protect the environment and the benefit of private ownership for the environment.

**Political effects.** Privatisation in developed and developing countries appears to have been pursued for pragmatic rather than partisan or ideological reasons and has generally not been a popular policy. Its impact will be profoundly affected by the quality of political institutions and could end up reinforcing power structures or leaving the state vulnerable to capture in regard to regulatory questions.

**Privatisation conditions.** There are a number general requirements for a successful privatisation, including: a well-paced programme; participation of foreign partners to bring in expertise and effective monitoring; development of market institutions; development of competitive market sectors; and development of effective regulatory authorities. There also appears to be a positive relationship with overall conditions of economic growth and political stability.

## Overall Assessment of Privatisation

There appears to be a strong consensus in the academic and international agency literature on the positive economic effects of privatisation. However, in some cases the evidence is not as strong as the overall policy recommendations might imply. Some literature has begun to test the privatisation orthodoxy, for example challenging the link between privatisation and growth.

## Alternatives to Privatisation

In a few cases, privatisation has been perceived as having failed, leaving the question of alternatives to privatisation:

- Corporatisation. Reform of public enterprises which stop short of privatisation are generically referred to as 'corporatisation'. These generally combine a mixture of contractual relationships between the firm and the government, redefinition of enterprises as commercialised companies facing hard budget constraints and sometimes private sector participation.

- Partial privatisation. A partial privatisation is one where the government seeks to retain a strategic holding in the company -- through a large percentage holding or golden share.

- Encouraging private entrants. Private operators may be introduced into a market where the state owned enterprise has traditionally enjoyed a monopoly.

- Public Interest Companies. In the last few years, there have been instances where privatisations -- either planned or implemented -- have been reversed. In most cases, these have been due to more or less popular campaigns. However, in a few cases, there have been explicit government initiatives to reverse privatisations, although the term 'renationalisation' has been avoided.

**PRIVATISATION IN ROMANIA**

## Legislation and Methods

A law passed in 1990 divided all state-owned enterprises (SOEs) into commercial firms and 'autonomous' firms, or 'regies autonomes'. The regies autonomes were declared non-privatisable, putting 47% of state-owned capital off limits for privatisation. Only in 1997 was legislation passed to reintegrate the regies autonomes into the privatisation process.

The legislative basis for the privatisation of the remaining SOEs, known as 'commercial companies', was established at the very start of the transition process, although Romania's legislation regarding privatisation has been continuously amended since.

**Main methods and objectives.** The choice of methods of privatisation reflected the political priorities of Romanian governments, and affected the outcome:

**1. Management-employee buyout (MEBO).** MEBO essentially gives away state assets, free of charge, to a firm's employees and management. In Romania, it became the dominant form of privatisation in the early transition period. It was very popular with the public; favoured the management of the SOEs involved (cementing political connections among managers and government members); and as direct sales of small companies attract little interest from local or foreign investors, there appeared to be no alternative.

One advantage of the MEBO method is that it may increase support for restructuring among employees and management. However, there are a number of drawbacks: it has a tendency to maximise income per worker rather than a firm's long-term profitability; by granting privileges to insiders, it effectively crowds out other potential buyers for the enterprise (thereby preventing any injection of new capital or know-how); and it transfers ownership from public to private hands, but without -- by definition -- provoking a change in the management or labour force.

**2. Mass privatisation programme (MPP).** The poor results of the privatisation programme in the first few years prompted a change of approach in 1994-95. The new emphasis was on mass privatisation, distributing shares to citizens so as to accomplish a mass transfer of ownership from the state to the private sector in a short period of time.

One advantage of MPP is that a mass transfer of ownership can occur despite low domestic savings and weak foreign investor interest. On the other hand, it does not bring in revenue for the state and results in a highly dispersed ownership. The Romanian MPP ensured an enduring dispersion of ownership by prohibiting trading of vouchers and the formation of intermediaries. The possibilities

for improving the performance of enterprises thus came only through secondary post-privatisation measures.

**3. Direct sales.** By 1997, it had become apparent that the MPP was ineffective in promoting enterprise restructuring, and in that year, a centre-right government more inclined to implement market reforms took office. Thus, an enterprise liquidation programme began, leading to the long-overdue closure of many failing industries, including the mining sector.

Direct sales to strategic investors are associated with the greatest post-privatisation gains in terms of enterprise restructuring. However, there were problems caused by a lack of transparency -- creating conditions in which corruption could flourish -- and the deals often included restrictions on the buyer's post-privatisation behaviour.

Privatisation through capital markets has not been a success in Romania. Although there were no legislative barriers to using this method, the poor state of financial market institutions and the uncertainty associated with such sales may have prevented this method from being used. Indeed, it was mainly used to supplement others, for the selling of small additional stakes in companies already majority privatised.

## The Impact of Privatisation

It is difficult to isolate the effects of privatisation per se in an economy undergoing a massive political and economic transition. However, a number of observations may be made:

**1. Macroeconomic impact.** While there appear to be no estimates of the impact of privatisation as an isolated factor on GDP growth in Romania, the economy started to see sustained growth only after the wave of direct sales.

The goal of attracting foreign currency to help relieve balance of payments problems was a key incentive for the Romanian government during the period 1997-99 when the foreign debt burden was extremely high. However, FDI never fully covered the current account deficit in Romania and was rarely a major source of capital inflows,

**2. Productivity and restructuring of enterprises.** The OECD finds that restructuring in Romanian firms has been slowest in companies controlled by employees and most effective in companies controlled by foreign strategic investors. Another study also finds that privatisation's positive effect on labour productivity in Romanian firms is greatest where the new owners are external holders.

While one study has also shown that case-by-case privatisation does not, on average, lead to greater productivity improvements than mass privatisation, improvements are nonetheless dependent on concentrated ownership and resultant restructuring -- which did not result from the Romanian mass privatisation experience.

**3. Foreign direct investment.** The first years of transition in Romania saw very weak foreign investment inflows. This partly reflected the predominance of the MEBO and MPP methods of privatisation, creating few opportunities for FDI. Firms privatised through MEBOs found it difficult to attract foreign capital even after privatisation. It was not simply the privatisation methods which deterred investors, but also the overall business environment. Once the government began to offer SOEs through direct sales in 1997, the pace of FDI inflows into Romania picked up rapidly.

**4. Service delivery.** Many public utilities in Romania remain in state ownership, undergoing the final stages of liberalisation and restructuring, and hence there is little evidence concerning the impact of privatisation on service delivery in the utilities.

The main utility privatisation which has been completed -- that of Romtelecom -- suggests that greater attention should be paid in future to the post-privatisation impact on market conditions and consumer services. The deal to sell Romtelecom to Greece's OTE appears to have been designed to OTE's great advantage and to the consumer's disadvantage.

**PRIVATISATION IN RUSSIA**

## Legislation and Methods

The privatisation of former state enterprises has been intended in principle to achieve a number of objectives: restructuring and investment; entrenchment of reforms (with a particular emphasis on equity and speed); fiscal relief; and the achievement of a number of social policy goals.

**Privatisation context.** Privatisation was undertaken in inauspicious circumstances and its development owed far more to political manoeuvring than to any more or less coherent plan. The process was launched amid deep economic and political crisis, with the most important problems being structural.

In this context, privatisation mechanisms employed in the 1990s reflected the government's weakness more than its radical ambitions. While this suggests that it would have been better to postpone privatisation, it is difficult to believe it would have been a more effective policy to keep more enterprises in the state sector.

**Methods of privatisation.** Numerous formal and informal privatisation mechanisms have been employed. The critical feature running through all of them is the predominance of insider (mainly managerial but also workforce) interests:

**1. Voucher privatisation.** The first phase of privatisation of large enterprises started in 1992 and was completed in mid-1994. It began with the conversion of such enterprises into joint-stock companies with 50-60% of stock allocated in voucher auctions open to all citizens. Radical government reformers generally opposed voucher privatisation, preferring cash sales and finding effective owners, but this was politically untenable:

- The process suffered from a number of significant problems. These included public lack of understanding; manager exploitation of insider knowledge; reinforcement of existing insider privileges; plant-level privatisation with creation of incoherent business units; assets whose value was difficult to determine; and short-termist behaviour amid economic crises.

- It also failed either to harden enterprise budget constraints or to de-politicise ownership. Insider resistance to restructuring or the loss of control to outsiders, together with the readiness of government bodies to help enterprises, enabled many privatised firms to avoid the choice between restructuring and liquidation.

However, the voucher programme did bring about a massive change in the structure of ownership. Moreover, it enabled the government to execute the first phase of privatisation without too much conflict, and there is evidence that privatisation brought improvements in the performance of enterprises privatised to insiders.

**2. Small-scale privatisation.** Small and medium-scale non-farm enterprises were disposed of during the same period by auction or through sales by tender:

- A large part of the firms in this category consisted of shops, catering establishments and consumer-service outlets. In this sphere more than any other, competition from new private firms has been significant and a study of Russian retail outlets found that the post-privatisation performance of business units made a convincing case for the greater efficiency of private ownership.

- Although many state shops were acquired by work collectives (insiders), the problems associated with insider control in larger enterprises were largely absent from the retail sector.

**3. Loans for shares.** A subsequent 'case-by-case' approach to privatisation produced a number of scandals. In 1995-97, the state transferred control over some of the country's most valuable enterprises to politically well-connected banks at extremely low prices. Loans-for-shares privatisations generally took place when the banks had managed to forge alliances with key industrial companies: hostile acquisitions were extremely rare and were fiercely contested.

**4. Other sales.** The pace of privatisation has slowed markedly since 1997. This is mainly because the most attractive assets had been substantially privatised, but is also due to the privatisation scandals of 1995-97, followed by the economic and financial crises of 1997-98, and the political uncertainties of the Yeltsin succession in 1999-2000.

The accession of President Vladimir Putin has brought some limited improvements in both investor sentiment and the state's performance in the field of privatisation, but Russia's privatisation record has not improved dramatically since the shares-for-loans fiascos. Transparency and competition is still limited, and in some cases the authorities have rewritten the terms of privatisation sales mid-process. Prices are now higher, with the most lucrative sales involving conflicts between rival business clans.

## The Impact of Privatisation

The overriding lesson has been that the significance of privatisation was greatly exaggerated at the beginning of the market transformation. The beneficial or detrimental effects of privatisation depend hugely on context and are thus inextricably linked to changes in the wider economic environment:

**Ownership structures and the problem of insider control.** By 1994, there had been at least some erosion of insider domination, which in the Russian context had brought problems for real market-oriented restructuring: there were implicit government subsidies for enterprises and the corporate governance framework made it easier for insiders to resist outside penetration and to abuse outside shareholders' rights when they did secure a foothold. The experience of Russia's earliest 'institutional investors' -- the voucher investment funds -- illustrate some of the problems.

**Enterprise performance and restructuring.** A study has shown that ownership change in Russia was already having some positive effects on labour productivity shortly after the conclusion of the voucher privatisation process, but that those effects were strongest in companies with concentrated outside owners.

The problems arising from insider control should not be exaggerated: there is evidence of higher average productivity and faster sales growth in privatised firms even where insiders retained control; that post-voucher changes in ownership structure were far from negligible; and that there was more restructuring under way in the mid-1990s than many realised at the time. Furthermore, changes in the broader economic environment have been accompanied by important changes in insiders' behaviour.

**Labour markets.** The impact of privatisation on labour markets has been one of the less studied aspects of the transition. However, evidence suggests that job destruction and worker separation rates

in Russian industrial firms rose in the early 1990s, as did job flows as a fraction of worker flows and layoffs as a fraction of separations. Private sector employment did not rise.

**Income distribution and poverty.** Contrary to popular perception, Russia entered the transition with significant inequality, which increased sharply after the transition began. Isolating the impact of privatisation with any precision is virtually impossible, although one study does suggest that privatisation served to magnify substantially pre-reform wealth inequality.

**The fiscal impact.** For the most part, Russian privatisation has served political rather than fiscal ends and has involved large-scale transfer at very low prices. Privatisation revenues generally formed a tiny part of the revenue of the consolidated state budget until 1997. In so far as privatisation has involved any fiscal benefits, these have been achieved via the separation of non-viable enterprises from the state budget.

## Sector-specific Issues

**Resource sectors.** The state's holdings in the country's crucial resource-extraction sectors remain considerable. Where privatisation has proceeded in resource sectors, as in the oil industry, it has been plagued by problems. For many of Russia's oil majors, the most important phase of privatisation was the notorious loans-for-shares scheme.

**Banking.** Bank privatisation has not been much of an issue in Russia, partly because the extremely liberal licensing regime of the early 1990s favoured the rapid emergence of a large population of de novo private banks.

Bank privatisation been limited to the three 'spetsbanki', which began in 1990, prior to the Soviet collapse. The process proceeded fairly rapidly, in a decentralised fashion, but the government received virtually nothing from the process; it was, to a great extent, a genuine give-away privatisation. However, the banks were solvent when it happened and the authorities never had to undertake extensive recapitalisation. At the same time, the rapid withdrawal of the state from the corporate governance of the banks freed them to compete with the rapidly growing new private banks. The result was that the banking sector became one of the most innovative and rapidly changing in Russia.

**Public utilities.** In principle, the Russian authorities are committed to restructuring the country's utilities and major infrastructure monopolies (gas, electricity and rail) by separating their 'natural monopoly' elements (the national grid in the case of electricity, the pipeline network in the case of gas) from their potentially competitive elements (gas production, electricity generation etc). In practice, this has proved extremely difficult, because many of the entities involved were part-privatised before the restructuring process began.

**Remaining state property.** To appreciate fully the impact of privatisation, it is necessary to consider the Russian state's performance as a property owner. The state has allowed its assets to be stolen, devalued and mismanaged, while managers and officials pocket a large share of the proceeds from their exploitation.

## PRIVATISATION IN SPAIN

### Legislation and Methods

Spain has implemented one of the largest privatisation programmes in Western Europe. However, the current government does not plan to privatise public services such as the letter post, railways, health, education and social services. Coal-mining, shipbuilding, air and seaport operation, and some radio and television channels also remain in state hands.

**Objectives.** Three phases in the privatisation process can be identified:

**1. Pragmatic privatisation.** Privatisation began under the PSOE in the early 1980s as a pragmatic response to industrial problems: the objective was essentially to save failing businesses.

**2. Revenue raising.** In the early 1990s also under the PSOE, the principal objective of privatisation switched towards raising money for the state.

**3. Asset disposal.** Following the PP victory in 1996, the privatisation programme was accelerated, the objective being to dispose of all state-owned enterprises. There were no longer strategic sectors nor special cases where the public sector should remain in control. The principal stated objective shifted to increasing efficiency, both of the privatised companies and of the economy.

**Privatisation process.** During the 1980s -- with some notable exceptions -- privatisations were of relatively small, mostly manufacturing, companies. The early 1990s were dominated in value terms by sales through flotations on the stock market of partial holdings in energy companies and in Telefonica. In 1996, the new PP government launched an explicit privatisation programme:

- The programme was embedded in a broader economic policy of liberalisation; was global in coverage; embraced full privatisation of the majority of major public enterprises (except for the retention of a ‘golden share’ in major companies); handed the main decisions over privatisation to managing agents; and embraced the principles of competition, transparency and independent valuations

- It divided companies in the public enterprise sector into four groups according to profitability and ease of privatisation: profitable companies with consolidated markets; companies operating in markets still to be liberalised, and where the sector required reorganisation; companies which still required consolidation and restructuring to guarantee their future; and companies that depended on the state budget and had been undergoing substantial reorganisation.

**Main methods.** A wide variety of methods have been used during privatisation operations in Spain. Most were trade sales, but the largest proportion of income has been raised through flotations. The government has favoured different methods of privatisation according to the type of company to be sold.

**Alternatives to privatisation.** Spain has adopted a number of forms of business organisation short of privatisation. These include the legal constitution of a ‘public trading company’; the use of contract programmes in which companies are allocated public funds on the basis of agreed targets; the division of companies into business divisions; and in the case of the postal service Correos, the break up of part of the business.

## The Impact of Privatisation

The impact of privatisation can be explored at a number of levels:

**Labour markets.** Privatisation affected five interrelated areas: labour costs, employment in former state-owned enterprises, unemployment levels, flexibility and trade union power. In terms of unemployment, while there were short-term job losses in many privatised companies, growth and diversification in the medium term resulted in job creation.

**Income distribution/poverty.** There is little direct reference to the impact of privatisation on income distribution -- either among individuals, social groups or regions -- or on poverty. Overall, privatisation, as part of a broader shift in the economy towards liberal capitalism, has probably contributed to a widening of the gap in income distribution.

**Investment and growth.** While the exact relationship with macroeconomic developments is difficult to determine, privatisation has been accompanied by a good growth record in comparison with other EU countries. In addition, all the large privatised businesses have substantially increased their investment in order to remain competitive.

**Impact on government fiscal and quasi-fiscal positions**. Under successive PSOE governments from 1982 to 1996, the best sale years saw receipts reaching 0.7% and 0.6% of GDP respectively. Under the PP government, receipts peaked in 1996-7 at 2.7% of GDP, among the highest in the OECD, having a significant impact upon public finances.

**Privatisation and competitive markets.** The process of privatisation alone has been insufficient to create competition. Where a former public enterprise had a dominant market share, privatisation transferred that market share to private ownership. Nonetheless, it is part of a gradual process of liberalisation, encouraged and increasingly demanded by the European Commission as part of EU-wide policies.

**Delivery of key services.** Since privatisation has occurred within the context of markets that have been undergoing liberalisation, it is not possible to separate the impact of privatisation alone on the delivery (quality, reliability and cost) of key services. There is no evidence that services to low income groups or less profitable segments of markets have deteriorated. All the major privatised service providers are now internationally competitive.

**Privatisation and regulation.** Spanish law has meant that hostile take-overs have been practically impossible, even for most of the companies quoted on the Madrid Stock Exchange, because of the widespread use of various forms of protection (particularly golden shares).

In terms of service delivery, sector regulators have ensured that prices have fallen significantly, services have generally improved, markets have gradually been opened to competition and privatised companies with dominant market positions have been restrained from engaging in anti-competitive practices. However, there is a danger of over-regulation which, along with continuous regulatory change, creates regulatory risk that can threaten investment.

Since the accounting scandals in the United States in 2002, the quality of corporate governance in all publicly quoted companies in Spain, as elsewhere, has been under the spotlight. In general the existing corporate governance of privatised companies is judged acceptable by international financial markets and by the regulators.

## PRIVATISATION IN ZAMBIA

### Legislation and Methods

In the early 1990s, the Zambian government embarked on one of the fastest rates of privatisation in Africa. While in other African countries privatisation was invariably undertaken as part of the conditionality attached to economic reform, Zambia was one of the few countries to elect a party which included privatisation in its manifesto.

**Economic development and state ownership.** Until recently, Zambia had a vast state enterprise sector which accounted for over 80% of GDP. Since 1992, the reformist Movement for Multiparty Democracy (MMD) has undertaken what many analysts describe as a 'radical' economic reform programme.

**Methods and objectives.** The key objectives of privatisation in Zambia can be summarised as: reducing state control of the economy; public finance rationalisation; economic efficiency; broadening ownership; and attracting FDI.

**Institutional framework for privatisation.** Although privatisation was first adopted as a policy by the former United National Independence Party government in 1990, it was not until a change of government in late 1991 that the process really got under way. The Zambia Privatisation Agency (ZPA) -- an autonomous body -- was created as the sole institution responsible for the divestiture of state enterprises.

Following the creation of the institutional framework, the MMD launched a comprehensive privatisation programme, which foresaw the privatisation of an initial 144 SOEs, including the Zambia Consolidated Copper Mines (ZCCM), one of the biggest companies in sub-Saharan Africa.

**Privatisation process.** The ZPA selected a group of companies to be privatised within a given period of time. The first tranche of very small companies were selected to test how the process of privatisation could be implemented:

- Direct sales. Given the absence of a well-developed capital market, the sale of SOEs has been the major mode of privatisation.

- Liquidation. Another method that ZPA has employed to end state participation in the economy has been liquidation.

- Management buy-out. A number of companies have been disposed of through the management buy-out approach.

A further important issue in the privatisation programme in Zambia has been how to increase public participation in ownership of the enterprises, given the low levels of incomes and savings.

**Purchaser characteristics.** It is frequently impossible to determine the new owners of the newly privatised firms, but available evidence suggests that in Zambia the number of genuinely African owners is somewhat higher than in other African countries.

Most of the enterprises sold to local Zambians were small companies, such as dry-cleaning companies, bakeries, farms, hotels and shops. Major companies have been purchased by multinationals.

The large proportion of indigenous owners could be attributed to the large number of employee and management buy-outs and the fragmentation of many SOEs into smaller units, especially in the agriculture and food processing sectors. Other explanations include limited foreign interest and the fragile economic situation.

**Initial success.** The main conclusion of virtually all research on privatisation in Zambia is that the programme has been highly successful, at least in the initial stages. However, the government has excluded strategic companies including enterprises engaged in sectors such as energy, communications, transport, and finance. There are a number of key success factors: government commitment, appropriate legislation, programme design and management, and transparency of procedures.

**ZZCM problems**. Given success in the early stages, the question was whether the government would be able to sustain its privatisation programme as more politically sensitive companies fell due for divestment. The problematic privatisation of Zambia Consolidated Copper Mines (ZCCM), which saw political interference and suffered from transparency problems, is illustrative here.

**Politics of privatisation.** In the more recent literature, it is generally argued that the ZPA has had difficulties in meeting its divestiture goals, especially in the privatisation of large SOEs, because of a number of factors:

- Many independent analysts observe that the privatisation process in Zambia has been disturbed by a considerable amount of political interference.

- Unlike the earlier stages, as the privatisation process progressed, little information was given to the public on the sale of large SOEs.

- NGOs, trade unions, professional associations, enterprise associations and opposition parties have raised serious concerns over the welfare consequences of the privatisation process.

The successful sale of SOEs is ultimately dependent upon government credibility, transactions transparency, prospective investor and government valuations, and knowledge of future privatisation.

## The Impact of Privatisation

The economic impact of privatisation can be evaluated in a number of ways:

**1. Fiscal impact.** An explicit goal of privatisation policy was to improve government finances from the proceeds of the sale of companies, and subsequently tax revenues from the expanded operations of the privatised firms. In this respect, modest gains have been made.

**2. Investment and Growth.** The overall emerging picture is that the privatisation programme has attracted investors from the United States, the United Kingdom, India, South Africa and Germany. There has been some greenfield investment, especially in the service sector. However, these achievements have been overshadowed by lack of growth in the economy, decline in many economic sectors, decreasing exports and lack of improvement in the standard of living.

**3. Market structure and competition.** There is some evidence that privatisation in Zambia has contributed to competition and improvement in the quality of goods and services at low cost to the consumer.

**4. Capital market development.** Some progress has been made with regard to capital market development. However, this has lagged behind privatisation and the amount of capital that could be raised through the sale of stocks and shares is very small.

**5. Social impact.** The privatisation process has had a major social impact in Zambia. But, as in the case of the economic impact, this should be separated from the broader effects of liberalisation on labour markets and income distribution (see below).

**6. Labour markets.** There has been a tendency to confuse the impact of SOE reform and broader economic liberalisation with the real effects of privatisation. However, there is a literature which claims that the impact of privatisation on job losses has been minimal.

**7. Income distribution.** There is no detailed information on the emerging patterns of income distribution in the privatised firms in Zambia, but it is expected that privatisation may have increased significantly the inequality in income distribution, particularly given job losses in certain sectors.

**Privatisation aftermath.** Available evidence indicates that some former SOEs, especially management buyouts, have collapsed after privatisation. Furthermore, the anticipated broad ownership of former state owned enterprises has not materialised. Only a handful of Zambian business people have benefited from the privatisation of SOEs, mainly owners of small enterprises.

**Lessons from the Zambian experience.** This assessment suggests that the overall level of privatisation under the MMD government in Zambia has been substantial. As a consequence, the face of the manufacturing sector has been completely transformed from one dominated by the state to a private-sector driven one, with many socio-economic benefits.

The Zambian divestiture experience suggests that a successful privatisation programme requires a number of features: political support and credibility; a supportive institutional and policy environment; an autonomous privatisation agency; careful programme design and implementation; transparent transactions and appropriate sequencing; donor support; privatisation through broad-based ownership strategies; and social sensitivity.

## PRIVATISATION IN NIGERIA

### Legislation and Objectives

Until 1986, the military governments conducted strongly statist economic policies seeking to acquire and control the greater proportion of productive assets. Private investors were deemed junior partners.

**IMF programme.** In 1986, a structural adjustment programme was launched under IMF auspices. The programme explicitly rejected the military government's recommendation that socialism should be the country's governing ideology. Although a privatisation decree was promulgated in 1988, of 110 state-owned enterprises (SOEs) then scheduled for full or partial privatisation, few were dealt with.

The 1988 privatisation programme was abandoned altogether in 1995 following a temporary return to import licensing and other economic controls. Alternatives to privatisation were proposed, including the leasing of SOEs to technical partners; awarding of management contracts and creation of joint ventures; and allowing competition with the state monopolies in electric power and telecommunications.

In 1998, a new programme of 'guided privatisation' was announced. Core investors were to be sought to take stakes in electric power, telecommunications, the oil refineries and other enterprises. None of these ideas bore fruit before 1999, when civilian rule was restored.

**Civilian rule.** In 1999, the elected president was not easily converted to privatisation. Nonetheless, a Public Enterprises (Privatisation and Commercialisation) Decree listed 51 enterprises for full privatisation and 52 for partial privatisation. The latter included the larger and more important federal SOEs with the intention to sell at most 40% of the equity of each to a private core investor.

The legislation created a National Council of Privatisation (NCP) as a policy-making body. A Bureau of Public Enterprises (BPE) was to provide the NCP secretariat.

**Policy objectives.** The objectives of privatisation policy are stated by the BPE to be reduction of the dominance of the public sector in the economy, so as to allow the private sector to play 'its proper role as the leading engine of growth'.

The BPE has published a list of 114 companies, fully or partially state-owned, that are intended for privatisation:

1. **First phase.** The first phase of the privatisation programme aimed to dispose of government shares in 16 enterprises whose shares were already quoted on the Nigerian Stock Exchange. A number -- notably Sadiq Petroleum and the Benue Cement Company -- became controversial.

2. **Second phase.** The second phase of the privatisation programme began in July 2000 and was intended for completion by May 2001. It was concerned with SOEs that sold their output or services at prices that were largely market-determined. The second phase has effectively become merged with the third and final phase, for which the original completion target was the end of 2001.

**Privatisation by business sector.** The poor state of SOEs creates major challenges for any privatisation programme. Utilities including telecommunications, electric power, petroleum products, ports and air transport have been of special concern:

1. **Manufacturing.** Most of the manufacturing SOEs are in serious financial difficulty or are no longer operating as going concerns.

2. **Telecommunications.** Despite considerable progress in the field of communications, there are still complaints that prices are too high, interconnectivity among the networks poor, and coverage confined to the big cities.

3. **Electric power.** The shortcomings of National Electric Power Authority (NEPA) are notorious, with about 70% of Nigerians lacking electricity and large businesses generating their own. The BPE plans to unbundle NEPA to create six generating and eleven distribution companies -- all to be privatised.

4. **Petroleum products.** Shortages of petrol, diesel and kerosene have been endemic, due to subsidy and refinement issues. Privately-owned refineries can now be licensed, but none have yet been built.

5. **Ports.** The seaports (other than oil terminals) are state-owned through the Nigerian Ports Authority (NPA), which has been fully commercialised since 1992. Shipowners and importers have long complained of congestion and high costs. Privatisation would require amendment of the Act that set up the NPA.

6. **Nigeria Airways.** While the government is favourable to the privatisation of Nigeria Airways, there have been a number of difficulties, with a controversial joint venture recently collapsing.

## The Progress of Privatisation

Although privatisation has been on the federal government's agenda for 15 years, little has been achieved. Not all the enterprises included in the first phase of privatisation have been sold. The second phase has made little headway, and its completion date has been repeatedly deferred. Most privatisations have been in banking, cement, and the marketing of petroleum products. The five major utilities -- Nigerian National Petroleum Corporation (NNPC), Nigeria Telecommunications (NITEL), National Electric Power Authority (NEPA) and Nigeria Airways -- remain entirely in public hands.

**Obstacles to privatisation.** In addition to industry-specific problems, there are a number of general obstacles to privatisation:

- The government has suggested that investors would be attracted by re-regulation, considering that much of the privatisation programme has become irrelevant.
- Domestic political wrangling has further hindered the privatisation process and ethnic rivalries are also an issue.
- Trade unions resist privatisation for fear not only of job losses but also because their members are often owed pay and have unfunded pension rights.
- The indebtedness of the SOEs is an additional impediment.

**Foreign direct investment.** The privatisation programme has failed to draw in significant foreign direct investment. For the most part, current investment proceeds independently of the privatisation programme.

**Central lessons.** The chief lessons to be drawn from the experience of privatisation so far are:

- expectations of how quickly it could be accomplished were wildly optimistic;
- enterprises with poorly maintained assets and uncertain financial obligations are unattractive to private investors;
- consequently expectations of the saleability of the parastatal sector were unrealistic; and
- deregulation has been more effective than privatisation in stimulating private investment.

# PRIVATISATION OVERVIEW

## SCALE OF PRIVATISATION

Although the 1980s saw significant asset sales in some developed (United Kingdom, France) and developing (Mexico) countries, it was only in the 1990s that privatisation took off:

- Global proceeds between 1990 and 1999 were 850 billion dollars, and proceeds were averaging around 150 billion dollars annually in the mid 1990s. In recent years, figures have fallen, particularly in developed countries (OECD, 2001).

- The bulk of privatisation proceeds have been raised in OECD countries, but between 1990 and 1999 approximately 250 billion dollars came from sales in non-OECD countries, a proportionately much more significant sum as a share of economic output compared to the share of privatisation in the industrialised world.

- Sheshinsky and Lopez-Calva (2000) state that privatisation has been a major contributor to the decline in the share of state owned enterprises' (SOEs') activity in economic output. During the 1990s, there was a fall from 15% to 3% of GDP in low-income countries and from 11% to 5% in middle-income countries (the decline was from 6% to 5% in developed countries). However, other sources note the rise of privatisation in developing and transition countries, but argue that it has been on a less dramatic scale -- Ramamurti (1999) argues that for most countries (notably low income ones) privatisation has scarcely influenced the share of SOEs in GDP.

## PRIVATISATION JUSTIFICATION

Three inter-related sets of reasons are used by national governments to justify privatisation:

- An economic analysis of SOEs argues that state ownership produces weak incentives for workers, managers and bureaucrats to ensure that public enterprises perform effectively and productivity, innovation and growth are improved. The economic critique further challenges the assumption that government as an owner is necessarily 'benign'. Some economists -- primarily on the basis of the experience of planned economies or of developing countries -- argue that the economics of rent seeking, political business cycles and corruption compound the problems of public ownership. For some critics, such is the dysfunctional nature of state intervention through ownership that almost any transfer to the private sector is an improvement (Shleifer, 1998; Shirley and Walsh, 2001).

- Governments, initially on partisan-ideological grounds but later more pragmatically, saw privatisation as a solution to a variety of policy challenges. From their perspective, the objectives of privatisation include improving macroeconomic conditions (by reducing budget deficits and indebtedness) improving the microeconomic climate (by increasing the productivity of firms, boosting investment and encouraging entrepreneurship) and winning elections (by improving economic growth, increasing public expenditure or cutting taxes and by creating or rewarding political clienteles through share ownership, etc.). There may also be a recognition of credibility benefits in economic policy-making which would accrue from a disengagement from interference and responsibility for previously publicly owned enterprises.

- International agencies, drawing upon economic analysis, encouraged governments in developing and transition economies to embark on reforms. Initially this was presented as a

recommendation (Cook and Kirkpatrick, 1988), but increasingly privatisation has become an aspect of conditionality (Bayliss, 2001). Even so, as our case studies show, such international pressures are likely to be secondary to the internal debate, particularly the domestic political and institutional context.

## THE IMPACT OF PRIVATISATION

The literature examines the impact of privatisation at both micro and macroeconomic levels:

### Profitability

Assessment of the impact of privatisation upon firms uses two main approaches: tracking samples of companies and analysing their performance before and after privatisation; and comparing the performance of state owned and private (including privatised) firms in particular sectors:

- Megginson and Netter (2001) draw upon attempts to compare the performance of firms before and after privatisation. Their analysis shows an increase in average profitability rates from 8.6% to 12.6% for a range of firms in developed and developing countries.

- Another analysis of profitability shows private rates are higher, but raises some questions over the dynamics and the contribution of privatisation. Derwent and Malatesta (2001) compare (mainly industrialised country) public and private firms' profitability on the basis of cross sectional and time series analyses: cross sectionally they study over 400 of the largest firms, private and public while the time series analysis focuses on a smaller sample of firms whose performance is tracked up to ten years before and five years after privatisation. The results of the cross section appear to bear out the claims for superior profitability: returns on sales are twice as high in private as in public companies while returns on equity are higher still. However, the comparison does not seem to take into account the tendency of many developed country governments to set relatively low profitability rates upon public enterprises and the fact that many of the companies are likely to be traditional monopolies where lower risks historically translated into lower returns. The time series analysis shows an overall improvement in firm profitability (possibly as governments relax controls and/or require higher returns to render the firms more attractive) before and after privatisation, but the authors highlight the extent to which the bulk of improvements occur before the privatisation.

Surveys of profitability in privatised firms in developing and transition countries are generally positive, but the best improvements are in the richer countries. A series of studies of Latin American countries cited in Kikeri and Nellis (2002) show a shift from unprofitability to profitability in almost all cases after privatisation, while Boubakri and Cosset (1998) find a significant improvement in profitability in upper-middle income developing states. Studies of low income countries -- relatively few given difficult market conditions -- seem to indicate more mixed results: Boubakri and Cosset's survey of privatised firms in sub-Saharan Africa (2002) shows only modest changes in profitability. For transition countries, Djankov and Murrell's (2000) review shows strong evidence for restructuring of firms which are privatised, compared with those in state ownership, though there are considerable variations, both between the countries of Central and Eastern Europe and those of the former Soviet Union, as well as on the basis of how the privatisation process was conducted.

### Efficiency

The impact of privatisation on the efficiency of firms is arguably the fundamental effect of the policy. Indeed in many countries- as our case studies show – there is much scope for improved performance

and efficiency. The condition of pre-privatisation SOEs in Zambia and Nigeria certainly highlights profound problems. Most of the analysis on efficiency and productivity has focused on comparisons between public and private firms, the latter embracing both already private and privatised firms. In a survey of over 50 studies (selected on the basis of citations and inclusion in major reviews), Shirley and Walsh (2001) conclude that 32 show private and privatised firms performing better than SOEs, whereas only five show SOEs performing better (15 show no difference or ambiguous results). The results appear robust for studies covering industrialised and developing cases (though in the latter there are no instances where SOEs perform better), but are clearer in the case of competitive markets than monopolies: in the latter case, six studies show private/privatised firms perform better while five show SOEs to be superior and five show no difference/ambiguous outcomes. The survey of surveys by Willner (2001) shows that out of 68 studies, a similar number showed superiority of public and private ownership (21 each). The sample includes a number of pre 1990 studies (49, mostly public private comparisons) and does not include many cases of competitive markets (most are either utilities or welfare services).

Studies which capture the impact of privatisation per se, summarised in Megginson and Netter (2001), appear to show an improvement in efficiency: sales per employee ratios rise from 97% in the year of privatisation to 123% thereafter with over 80% of firms reporting increases in output per employee. The results appear to be robust for developing countries: Boubakri and Cosset's (1998) study shows an average improvement of 25% in sales per employee -- though their (2002) analysis of low income African countries shows no improvement in efficiency.

According to some analyses -- based admittedly on developed countries -- the bulk of efficiency improvements in privatised companies took place before the act of privatisation. Derwent and Malatesta (2001) suggest that it is as much the process (or perhaps the promise) of privatisation possibly more than privatisation per se that drives the improvement (though the authors suggest that the end-result of privatisation is needed to ensure that improvements are perpetuated). In the case studies examined, privatisation seems to have improved the performance of many of the firms affected (Spain, Russia and Zambia) though in the latter case the effect has been masked by overall economic problems. The Romanian case study indicates that the extent of improvement depends on the way in which privatisation takes place – the biggest changes have taken place in those companies where an ownership is acquired by an external actor whereas insider privatisations tend to have more mixed results.

## Fiscal Effects

The most comprehensive analysis of fiscal and macroeconomic effects (Davis et al 2000), covering 18 countries in the developing and postsocialist world, shows a substantial injection of revenue from privatisation (the cumulative amounts are estimated to be equivalent to 2% of the countries' GDP). There has been some debate about the extent to which governments have used privatisation revenue to boost public spending or cut taxes. This has been reflected in policy terms with bodies such as the World Bank arguing that new revenues should not be the main determinant of privatisation policies. While some developed countries such as the United Kingdom in the 1980s have used privatisation revenues to resource current expenditure it appears that most developing and transition countries have not done so. Econometric assessments indicate that, overall, privatisation revenues tend to be used to reduce debt levels rather than for current expenditure (Kikeri and Nellis 2002). While the authors of this work admit the evidence is limited, their finding would seem to be consistent with other analyses: some commentators argue that the revenues from privatisation have come "too little and too late to help much in resolving fiscal crises" (Pinheiro and Schneider 1995, p.753) while others have observed that privatisation is not generally carried out by governments facing severe budget deficits (Biglaiser and Danis 2002).

Beyond the immediate windfall of sales proceeds, some analysts have examined the post privatisation fiscal effect. For the most part such research claims that privatisation has involved a reduction in government transfers to public enterprises (Davis et al 2000); it is unclear how far this is due to the smaller stock of public enterprises or improved performance by the residual public firms. Moreover, there appear to be much lower levels of transfers from government to privatised firms (in the form of subsidies or other payments) than there had been when the firms were under public ownership (Kikeri and Nellis 2002), though this may not always be so. In the UK, the British railway sector has received much greater subsidies since privatisation than it received when in public ownership (Tyrrall and Parker 2001), while the Russian case study in this project indicates that subsidies to privatised industries have been sustained, albeit in a more opaque fashion. There is also some uncertainty over the impact of privatisation on tax revenues. Some argue that privatisation has increased the revenue base for governments (Barnett 2000), but in the case of developing countries it is not clear how far this is the case given some instances of formal tax relief granted to new owners (Bayliss, 2002), and informal tax avoidance and evasion more generally (Kikeri and Nellis, 2002; Davis et al 2000). While there seems to be a general consensus that the combination of lower levels of transfers from government to firms and higher levels of taxes from firms to governments has contributed to a decline in budget deficits, it is not possible to disentangle these effects from other reforms taking place (Sheshinski and Lopez-Calva, 2000).

## Growth Effects

The impact of privatisation on overall growth is hard to isolate: privatisation does not take place in a vacuum and for the most part countries engaged in the policy are also committed to a range of other reforms. Sheshinski and Lopez-Calva (2002) note that there is no strong evidence of the effects of privatisation at the macroeconomic level. While pointing to a strong correlation, the IMF survey (Barnett, 2000) is itself careful not to attribute causality between privatisation and growth. Kikeri and Nellis (2002) concur with the IMF survey arguing that privatisation acts as a proxy for a range of structural reform measures signalling reform credibility and seriousness to investors and markets. The question remains how far privatisation per se contributed to economic growth. Cook and Uchida (2001) question whether privatisation has a positive effect not least because of the risk of poor regulation. In a survey of transition economies, Sachs et al. (2000) conclude that ownership is not enough and that a range of policy and institutional reforms need to be in place to ensure that the economy as a whole gains from privatisation. Indeed, the evidence from our case studies on Romania and Russia not only confirms that privatisation is a necessary but not a sufficient condition for reform but also that without the latter, the impact of privatisation may be blunted.

## Market Development

In a survey of mainly industrialised economies Megginson and Boutchkova (2000) argue that privatisation has contributed significantly to the development of capital markets, that privatised firms are often among the most valuable companies in local stock markets and that privatisation has contributed to an increase in the number of shareholders (though there is a tendency for many new investors to sell up relatively quickly, securing whatever windfall gains are available). It is less clear how far these effects spread beyond the privatised firm itself, particularly in developing countries. In Korea and Mexico, privatised firms constitute large shares of total market capitalisation and while privatisation has been good for international investment banks, it is not clear how far they have promoted the development of local financial markets. The increasing trend towards pension privatisation in the developing world may have a more significant effect on capital markets. In terms of investment effects, d'Souza et al. (2000) find that privatisation has boosted the capital expenditure of the firms involved. They stress though the importance of the general policy context in securing wider economic benefits, a point reiterated by Boubakri et al. They identify generally positive results from privatisations in developing countries but argue that the policy is most effective when preceded

by stock market and trade liberalisation. However as the Zambian case shows these conditions may themselves be hard to create or sustain: on the one hand the capital market is underdeveloped – with only nine companies registered on the local stock exchange; on the other the country's generally liberalised trade regime has left local companies exposed to competition from firms in neighbouring countries which still retain protectionist policies.

## Consumers

Consumer gains from privatisation largely depend on the nature of the firm being sold. Where the firms are operating in open and competitive markets, consumers will benefit from increased choice, innovation, quality of service and lower prices assuming that effective competition and trade policies are in place. Where privatisation takes place in infrastructure/monopoly services -- much of privatisation has focused on such activities -- consumer gains are not automatic and will depend on the exercise of regulation. The question is further complicated by whether or not market liberalisation measures are introduced: while the general opinion in the academic literature is that market organisation is more important than ownership in ensuring consumers benefit (Vickers and Yarrow, 1988) others argue that ownership reform is a vital guarantor of effective competition (OECD, 1999).

Evidence on the impact of privatisation is that consumers overall generally have gained from utility privatisations. Chisari et al.'s (1999) analysis of utility privatisation in Argentina shows that all groups in society have benefited though not equally. A more general conclusion is that privatised utilities have been keen to expand their markets, thereby increasing connection rates to their services, but in the process the cost of service also increases (Birdsall and Nellis, 2002; Gray, 2001). However, Wallsten's (1999) survey of telecom privatisations in Latin America and Africa shows that privatisation in conjunction with regulation is associated with increased access (though this may reflect the changing economics of telecoms technology).

## Employment and Equity

It is possible that privatisation could have beneficial effects not only for the firms and governments concerned but also for the economy as a whole yet still have serious adverse distributional consequences. Birdsall and Nellis (2002) note that, privatisation programmes have done more to enhance efficiency than equity -- at least initially, and on average have worsened wealth distribution and income distribution. The first effect is due to the effect of transferring state assets to the relatively richer members of society able to afford to purchase them (and as the Russian case confirms, the terms on which this takes place may be far from equitable). Those surveys which examine this aspect tend to confirm this outcome (summarised in Birdsall and Nellis). In extreme cases, assets may be allocated on the basis of insider (Sachs et al. 2000, Djankov and Murrell 2000) or political connections (Cook and Kirkpatrick 1995). Nonetheless, for the most part studies on the distributional impact of privatisation have focused on specific employment and equity issues:

**Employment.** The employment effects of privatisation are a major issue in the debate on the policy's impact. In much of the literature on public ownership, it is argued that SOEs tend to be overstaffed as a form of job creation/political patronage despite the cost to company and government finances. In such cases privatisation is seen as a way of reducing inefficiencies and misallocation of labour: while not the only source of productivity improvements seen after privatisation, a reduction of inputs such as labour is likely to be part of the equation. Critics of privatisation by contrast have also seized on the employment effects as one of the focal points for campaigns against sell-offs. In fact the evidence is relatively mixed: Birdsall and Nellis suggest that while privatisation may entail job losses in the short run, over time the improved performance of the firms leads to a recovery in employment. However, they admit that, on balance, more people lost jobs than gained through privatisation.

Surveys such as D'Souza, Nash and Megginson (2000) find insignificant employment declines overall (although in cases of uncompetitive enterprises large reductions have taken place). Job losses may occur before privatisation takes place as part of a restructuring process. Kikeri and Nellis (2002) suggest that this would happen whether or not privatisation took place (and there is some evidence for this from wider trends towards downsizing the public sector -- see Rama 1999). Where firms are competitive and/or operating in growth sectors, employment increases. It is questionable whether such additional employment can be attributed to privatisation per se if inevitable job losses are not seen as due to privatisation. In terms of the treatment of workers under privatisation, the general evidence seems to suggest that in most cases salaries and working conditions have been stable (ILO, 1998). One critic of privatisation recognises that in some countries privatisation may constitute an improvement on employee treatment under state ownership (Bayliss, 2002). Nonetheless, there remains a widespread perception that the overall impact of privatisation upon labour is negative (Pripstein, Posusney and Cook, 2002).

**Equity.** Attempts to quantify the effect of privatisation on equity have tended to focus on the sub-sector of public utility sales. These have often been among the most attractive targets for privatisation but have also been some of the most controversial. Analysis of the issue has often been characterised by profound differences of perspective with economic analyses focusing on the overall economic effects of reform, while advocacy groups have highlighted the hardship experienced by low income households:

- Chisari et al.'s (1999) examination of privatisation and regulation of utilities in Argentina shows distributive gains for all groups though the scale of benefits appears to depend upon the effectiveness of regulation. In an account of the effects of privatisation and reform on universal service, Clarke and Wallsten (2002) seek to highlight the shortcomings of the pre-privatisation status quo. According to their analysis cross subsidies were inadequately targeted and failed to reach poor consumers. Estache et al. (2000) argue that given the generally poor financial state of the utilities, service quality and access were limited and poor consumers were forced to take up more expensive alternative sources of supply (see also Leipziger and Foster, 2002). There is a general recognition in this literature that privatisation will raise tariff levels because prices have been held down in the past but that overall levels of service improve. Moreover, with the right regulation and pro-poor mechanisms in place the impact on the poorest can be mitigated (Estache et al., 2000; Franceys and Nixson, 2001).

- Bayliss (2002) argues that privatisation of utilities has been focused too much on gaining the best deal rather than on the interests of end users and draws attention to serious shortcomings in the conduct of many privatisations. She highlights cases where the measures taken to make utilities financially sustainable -- tariff increases and disconnection programmes -- have affected the poorest groups in developing countries. Casting doubt on the wider benefits of privatisation of such sectors, she argues that privatised utilities are able to exploit their market -- and political -- power while regulation in most developing countries is broadly ineffective: even where regulatory contracts or concessions are effectively designed, private operators will seek to revise their commitments.

## 'Externality' Effects

Externality effects are felt at a number of levels:

- **Research and development.** Observations in developed countries show that privatised firms tend to reduce their commitments to research and development (R&D). The decline was particularly apparent in the case of the UK energy utilities where a major scaling back took place (though this may also reflect the change in incentives which followed market

liberalisation in these sectors). However, there is relatively little research on the issue. The trend towards a reduction in R&D commitments is to some extent countered by the improved productivity of surviving research activities (Munari, 2002).

- **Environmental protection.** Many critics of privatisation particularly as it affects developing countries, have argued that in the trade-off between a clean environment and private profit, the latter prevails and that private investors will take advantage of poor regulation to engage in production that is polluting. However, proponents argue that this criticism underestimates both the limitations of pre-privatisation structures to promote or protect the environment and the benefit of private ownership for the environment. As regards the record of SOEs, the experience of the former Soviet Union and East European states is held up as an exemplar of disregard for pollution and damage to habitats. The case for a beneficial impact from privatisation rests on a number of factors: the indirect effects of privatisation in terms of new investment and greater efficiency; the potential of more effective environmental regulation of privatised enterprises and commercial pressures to improve environmental performance (Lovei, 2002). Evidence on the effects of privatisation (negative or positive) tends to be anecdotal, focusing on particular cases (in some instances countries or, in the case of critical accounts, firms). Thus while a recent study by the World Bank on the Implications of Privatisation for Environment (2002) asserts a positive relationship, identifying a number of reasons why this should be so and making recommendations on how to ensure this outcome, there is no empirical evidence given beyond case studies and some surveys of private investment (rather than privatised industries per se).

## Political Effects

Privatisation in developed and developing countries appears to have a differing political impact. As noted above some governments have the tendency to see privatisation as a means of solving a variety of economic policy problems and/or secure political gains. What appears clear is that the motivation for such actions owes relatively little to partisan or ideological factors. Whereas political rhetoric and some analyses (Boix, 1997; Perotti, 1995; Siniscalco et al. 2000) have indicated that this was the case, the diffusion of privatisation in the 1990s and subsequent analyses suggest that the policy has been 'mainstreamed' (McGowan, 2002) and that governments have pursued privatisation for largely pragmatic reasons (Bel, 2002). Nonetheless, privatisations appear to be more often conducted by democratic than authoritarian governments and by relatively richer developing countries than poor ones (Biglaiser and Danis, 2000).

For the most part, especially in developing countries, privatisation has generally not been a popular policy option: the overall economic impact, even assuming that it is positive, is relatively invisible whereas the adverse consequences are more apparent -- job losses, higher prices for essential services, etc. Although some research has called such arguments into question highlighting electoral support for reform processes, they tend to pitch their analysis above the question of ownership (Armijo and Faucher 2002). Even strong supporters of the economic benefits of privatisation recognise that the policy has been unpopular in many countries (Leipziger, 2002; Birdsall and Nellis, 2002).

The political problems may also reflect the fact that the impact of privatisation will be profoundly affected by the quality of political institutions and can reinforce tendencies within those institutions (a finding confirmed by our cases from transition and developing countries). This is clearest in relation to questions of transparency and corruption in the process of privatisation (Sachs et al. 2000, Djankov and Murrell, 2000). On the basis of Shleifer-type arguments, privatisation should improve governance overall by removing scope for patronage and corruption. The manner in which privatisation takes place may end up reinforcing power structures and the state may still be vulnerable to capture in regard to questions of regulation and trade policy (Bayliss, 2002).

## Privatisation Conditions

While most of the analyses examined in this section have taken an aggregate approach to the assessment of privatisation and have been less concerned to discuss what factors facilitate or undermine effective privatisation, it is possible to identify some elements that seem to help or hinder the process. It is worth bearing in mind that to some extent the answer depends on what objectives are being prioritised. Thus a well administered privatisation may bring about performance improvements in the firms affected and help to foster better fiscal and macroeconomic conditions, yet bring about a more unequal distribution of income and wealth within the society.

From the literature examined and from the case studies examined later in this report, the general requirements for a successful privatisation appear to include:

- a well-paced programme of sell-offs (as opposed to a big bang);
- participation of foreign partners to bring in expertise and effective monitoring to the firms affected (rather than mass privatisations which can bring little management control and indeed facilitate 'looting' by incumbents);
- development of market institutions (stock markets, legal systems, corporate governance regimes) before privatisation;
- development of competitive market sectors (including openness to international trade) before privatisation; and
- development of effective regulatory agencies prior to privatisation of utility and infrastructure industries.

There also appears to be a positive relationship with overall conditions of economic growth and political stability: privatisation appears to have been more successful in middle income countries than in low income countries with governments committed to economic reform (rather than opportunistically using privatisation as a source of short-term revenue). Among the countries which seem to have been more effective at privatisation are Mexico and Hungary, while poor performers include Russia and other former Soviet states.

It can be argued that, beyond ensuring that the process takes place transparently, effectively and with a good return to the government, privatisation should not seek to pursue any other objectives. Pursuing too many objectives in a privatisation leads to difficult trade-offs and scope for strategic behaviour by officials, management or bidders. However, given the distributional consequences of privatisation, the question of equity might be an important exception to this rule. Utility privatisations are among the most sensitive both inside the countries affected and more widely. Accordingly it is advisable that privatisations in this area are underpinned by a careful assessment of the consequences for the poorest groups in the countries affected and by the formulation of remedies to address any adverse effects. Ensuring that tariff increases are affordable for lower income groups and that a credible regulatory framework is in place -- is an essential prerequisite for privatisation. In addressing these issues the case of Chile stands out as a model for emulation (Estache et al., 2000).

## The Post Privatisation Environment

The impact of privatisation is in almost all respects mediated by the post privatisation policy context. It might be argued that some aspects -- such as the profitability of industrial enterprises -- are effectively removed from the public domain. However even here there will be an impact. As noted

earlier, the context of corporate governance and commercial law is very important and will be shaped by government policies (Megginson et al 1999; Dyck 2001). Privatised firms may also engage in rent seeking behaviour (protection, licenses etc). In both cases however these issues arise for privatised firms as private firms. More specific consequences are likely to arise where there have been conditions attached to sales which require the privatised operators to honour commitments with regard to investment, employment, etc. In these cases -- usually where a foreign investor acquires an enterprise -- the question of enforcement arises.

However, the post privatisation policy environment is likely to be of greatest significance where there is a need for continued and detailed oversight of the industry by government or where government (or government owned entities) are involved as partners or customers. This aspect is often important in the case of utility and infrastructure privatisations, extending into questions of the price and quality of service provision. In most cases the initial commitments of the privatised firm will be specified as part of the terms of sale but the follow up will be carried out by the regulatory authority.

Evidence from actual cases -- and to a lesser extent the economic literature -- concerning post privatisation and regulation shows that disputes between privatised firms, regulators and governments are by no means unusual and arise in developed, transition and developing country contexts. In developed countries such cases (usually between regulators and firms) are subject to some appeal by another organisation such as the competition authority or judicial review (the latter is particularly common in the United States albeit between regulators and long established private firms). While such disputes may be disruptive, for the most part they are handled within the institutional frameworks envisaged for the purpose. In transition and developing country cases the situation is less clear: in Hungary a dispute over electricity regulation involving a US owned utility was only resolved after legal action in the US Courts (McGowan 2002); the controversy over water privatisation (and re-nationalisation) in Bolivia is currently under international arbitration.

Such cases are interpreted by critics of privatisation as the result of unfair regulatory settlements imposed by the pressures to privatise, and ultimately only resolvable by a reversal of privatisation (Bayliss 2002). Supporters of privatisation tend to regard them as failures to design appropriate regulatory systems and recommend the design of credible regulatory frameworks, ensuring independent agencies with limited discretion, minimum scope for government intervention and renegotiation and mechanisms for appeal and arbitration (Guasch and Spiller 1999). Whether such conditions can be met in countries without the state capacity to deliver independent regulation or legal procedures is debateable (Hellman et al 2000).

## OVERALL ASSESSMENT OF PRIVATISATION

There appears to be a strong consensus in the academic and international agency literature on the positive economic effects of privatisation. However, in some cases the evidence is not as strong as the overall policy recommendations might imply. There has been remarkably little academic literature that articulates the 'downside' of privatisation or the apparent benefits of SOEs. There are criticisms of privatisation but they tend to focus on questions of ideological bias (this issue figures prominently in the critiques offered by PSIRU). Even critiques from within the economics discipline tend not to adopt the techniques of that mainstream. One such critique, by Chang and Singh (1998) criticises the World Bank's 1995 study 'Bureaucrats in Business'. The authors identify important theoretical and empirical shortcomings but choose to focus on the former, highlighting the tendency of the report to downplay market failures and to overstate government failures. Beyond general assertions on developments within China there is no real attempt to demonstrate the strengths of SOEs. A theoretical attempt to do so is provided by Willner (2001) but he confines empirical support to the literature survey noted earlier.

There have been a few attempts to examine and test the privatisation orthodoxy. Another critique of the 1995 World Bank study, by Jalilian and Weiss, investigates one of its underlying hypotheses (that countries with large state sectors perform relatively less well), but finds that the results of their tests are inconclusive, indicating that there is no per se argument that the size of the state matters. Cook and Uchida (2001) have explored the relationship between privatisation and growth -- presented by Barnett (2000) -- and called into question such claims. They argue that if anything there appears to be partial correlation between the two factors indicating that privatisation has had a negative effect. More generally, they counsel caution in engaging in such exercises given methodological difficulties and problems in determining causation, but suggest that other policies may be as significant (notably competition policy and regulatory capacity).

## THE CONTRIBUTION OF MULTILATERAL AGENCIES TO PRIVATISATION

As noted earlier, one of the factors behind the trend towards greater privatisation has been international pressures. This has been true more for developing and transition economies than for industrialised countries (though arguably bodies like the OECD have recommended privatisation in at least some economic activities in some of its member states). Such pressures have been exerted primarily in the context of financial aid (though the issue has arisen with regard to the EU accession negotiations of a number of Central and East European countries) and has been apparent in bilateral (notably the United States) and multilateral linkages.

The nature of that pressure has arguably become more intense over time. Whereas privatisation has been an option recommended by the World Bank and International Monetary Funds for most of the last two decades, it was seen in the context of a wider process of public sector reform and indeed was one of a number of options. Indeed initially privatisation was not an absolute requirement for receipt of financial assistance (at least from the World Bank). Over time, however, the multilateral institutions have placed more emphasis upon privatisation and private sector participation. As is clear from the position presented in much World Bank research, reforms falling short of privatisation have been regarded as ultimately unsuccessful. Privatisation has accordingly featured as a condition of loans from the major multilateral agencies, in Structural Adjustment Programmes and in the Poverty Reduction Strategy. In addition, the Bank, along with regional development banks, is closely involved in funding infrastructure projects and encouraging the participation of private capital in such projects.

There are three other important roles played by multilateral donors:

- They have been staunch advocates of privatisation, conducting and disseminating research which they regard as demonstrating the effectiveness of the policy (much of the research consulted in this literature review was produced by or for the World Bank for example). Such research has sought to transfer "best practice" in the conduct of privatisation, the design of regulation and the development of the legal and commercial infrastructure required for these policies to be successful.

- The other principal role of the institutions is the provision of advice and expertise. In this regard the main activity of the Bank has been to provide financial and technical assistance for the capacity building (developing the policy, institutional and legal frameworks).

- The third aspect of Bank work relates to financial support to facilitate privatisations (funding one-off charges, consultancy, the financing of restructuring programmes for privatised companies, etc)

Perhaps even more so than the literature on the impact of privatisation, the literature on the contribution of multilateral organisations to privatisation is divided into two camps. On the one hand

there are the publications of the multilateral organisations themselves -- these have tended to stress the role of such agencies in ensuring effective implementation of privatisation and in some cases to engage in some self-criticism over their own contribution to the privatisation process (see Cook and Kirkpatrick 1997 on the World Bank). On the other hand is the literature of NGOs and others which is critical of the multilateral agencies' involvement in encouraging privatisation (PSIRU 2002). In practice the actual effect of such agencies seems to vary, as our case studies show: whereas Bretton Woods Institutions seem to have been effective in shaping the direction of change in Romania and arguably Zambia, in Nigeria and Russia, their influence has been more limited, with domestic factors prevailing (whether to progress or obstruct the policy).

## ALTERNATIVES TO PRIVATISATION

Considerable theoretical and empirical work supports privatisation. However, some argue that privatisation is not appropriate to all sectors and all countries. Moreover, in a few cases privatisation has been perceived as having failed, leaving the question of alternatives to privatisation:

**1. Corporatisation.** Reform of public enterprises which stop short of privatisation are generically referred to as 'corporatisation'. These generally combine a mixture of contractual relationships between the firm and the government, and redefinition of enterprises as commercialised companies facing hard budget constraints. Reform measures are generally intended to capture at least some of the supposed benefits of private ownership and/or to limit government intervention. However, their ambiguous character raises the question of whether they constitute an end result in their own right or a transitional measure on the road to privatisation. If privatisation is not under consideration it appears to be because it is considered too delicate an issue for the sectors and/or countries concerned.

The 1995 World Bank summary of evidence on SOE reform focused on two types of contractual arrangement which stopped short of privatisation: performance contracts (where the contract is between government and government employees running the SOE) and management contracts (where the contract is between government and a private firm contracted to manage an SOE). On the basis of a sample of twelve companies in six countries, the study found that overall performance contracts failed to improve SOE performance (with just three showing improvement in productivity and profitability). Rarely used management contracts appeared to be more effective -- improving operations in two thirds of the twenty cases examined. Subsequent research seems to confirm that performance contracts are not effective (Shirley and Xu, 1997) and that such policies were administratively difficult to implement (Shirley, 1999) and were still affected by the political considerations of governments (Morris et al., 2002).

**2. Partial privatisation.** Similar concerns have been raised over the effectiveness of partial privatisations as an alternative to a full sell-off. In contrast to a phased privatisation where the government has the potential to maximise revenues by releasing tranches of shares according to market conditions, a partial privatisation is one where the government seeks to retain a strategic holding in the company -- through a large percentage holding or golden share. In principle, such a mechanism is designed to obtain the best of both worlds: on the one hand, such a sell-off provides access to funds (for the government or the enterprise) and private sector management skills; on the other, it allows the government to ensure that the 'public interest' and/or specific public policy objectives are maintained. However, in practice, there is the risk that governments will intervene too much and that the efficiency effects of private investors and capital markets will be blunted by the lack of a 'bankruptcy constraint'.

**3. Encouraging private entrants.** Striking a balance between such objectives might be better met by introducing private operators into a market where the state owned enterprise has traditionally enjoyed a monopoly. The new entrants provide the competitive incentive while sustaining the SOEs permits the government to address public policy goals (eg. maintaining employment levels). This will

take a variety of forms depending in part on the sector of the economy and the starting point of policy. Where the state was the sole owner of most economic activities, for example in Poland, new firms established in competition with SOEs undergoing more or less restructuring constituted a more important source of private ownership than the privatisation programme. Trade liberalisation may have a similar effect, allowing imports of foreign goods to compete with goods produced by local SOEs. Another possibility is that the government may opt to reorganise a particular sector by selling off some segments or enterprises as going concerns while retaining ownership of others. However, while such mechanisms can provide a spur to restructuring and shrinking of the state sector, they may be hamstrung by the privileged access of incumbent state enterprises to government and much will depend on the effectiveness and independence of competition authorities and regulators.

**4. Franchises/Concessions/Public Private Partnerships.** Another option is for government to retain ultimate ownership of an economic activity but to contract it out to private operators (though in some cases incumbent public operators can tender for the contract). Normally reserved for basic public services, infrastructure provision or for support services within government, this system of "competition for the market" is intended to secure the optimal balance of financial benefits (either revenues to government or limited subsidies from government), private sector skills (in project management and service delivery) and service standards (social obligations, quality of provision, etc). Such contracts -- variously referred to as franchises, concessions, public service contracts or, most recently, public private partnerships -- can be relatively short term (as in the case of waste management or public transport provision) or long term (as in the case of water services).

The debate on such mechanisms has focused on a range of issues (Klein 1996, Dnes 1995) including:

- questions of the allocation of risk (how much is borne by the franchisee and how much by the government, for example in the allocation of uncontrolled costs or unanticipated delays);
- contract design (how far to specify targets for output and investment, choice of regulatory mechanism);
- processes of bidding (auctions versus negotiation, transparency and discretion in awards); and
- competition policy concerns (how many companies bid for the contract given the increasing costs of tendering, political risks, etc) (Savas 2000).

Evidence on the use of concessions and franchises is mixed. While there is substantial evidence on cost savings to be obtained from contracting out of services (Savas 2000 shows savings of between 20% and 50% in urban transport services), comparisons of longer term franchises (in for example water) is much less clear: Estache and Rossi (2002) show that levels of efficiency of Asian public and private water utilities are broadly similar while Estache and Kouassi (2002) show that levels of efficiency in African public and private water utilities are broadly similar and predominantly poor. Evidence on PPPs is at a particularly early stage and while substantial claims have been made by some governments for the success of this model (UK Treasury 2000) other analysis is more mixed (IPPR 2001). The very limited evidence on PPPs in developing countries shows that while well designed projects can deliver improvements in services there is a need for municipalities to have the capacity to negotiate effectively (Nickson and Franceys 2001).

**5. Public interest companies/'renationalisation'.** Where they are effective, options such as corporatisation appear to be at best transitional steps in the direction of privatisation. Until recently, moves away from privatisation have been scarcely discussed. The literature supporting privatisation is dismissive of the benefits of a return to public ownership or even of a shift back in that direction. The arguments of Shleifer and others seem to predispose them to rejecting public ownership per se (in Shleifer's case to see little role for government at all). Almost no market failure justifies public ownership with those recognising flaws in the privatisation process arguing that privatisation is the

least worst option. Nellis implies that privatisation failings are likely to be the result of the same government failing which hindered the management of SOEs. Generally, the response to critics has been that without privatisation the situation may have been worse. Shirley and Walter (2001) argue that the critics fail to provide counterfactuals of how the sectors would have evolved in the absence of privatisation.

In the last few years, there have been instances where privatisations -- either planned or implemented -- have been reversed. In most cases -- for example in the water sector (Hall 2001) -- these have been due to more or less popular campaigns. However, in a few cases, there have been explicit government initiatives to reverse privatisations -- in the United Kingdom and New Zealand -- though the governments involved have been careful to avoid the term 'renationalisation'.

In 2001, after much public criticism of its poor financial, operating and safety performance and in the face of spiralling subsidy requirements, the UK government put the rail infrastructure company Railtrack into receivership as the first stage of restructuring. While popularly referred to as a renationalisation (and the government is in effect the ultimate guarantor of the company), the new arrangements for Network Rail (as the company is now called) set out a system where the company is not part of the government balance sheet, bonds are raised commercially and management is provided by the private sector (Grayling, 2002). One of the precursors of this solution was a 'deprivatisation' or 'mutualisation'. In 2001, the privatised water utility in Wales was purchased by a consortium of bidders established as a Company Limited by Guarantee, essentially a not for profit company funded by bond issues rather than shares. The company -- Glas Cymru -- sought to ensure that water prices were reduced and investment was maintained in Wales. The company is a group of stakeholders rather than shareholders and any dividends are reinvested in the company. Most of its operations are contracted out by competitive tender (Glas Cymru, 2002).

These innovations have renewed interest in public interest/not for profit companies. The claimed advantages of these options -- adopted in response to the perceived failure of privatisations -- is firstly that they are run commercially but are not owned or controlled by external private shareholders, and secondly that they emphasise public interest concerns and provide accountability mechanisms while remaining independent of government (IPPR, 2002). Whether such organisations will be more effective than precursors remains to be seen and there are important uncertainties with the new models, regarding oversight and the apportioning of risk in the sectors where these companies operate but contract out much of the maintenance and operating activities. Given that these changes have taken place in the last year there is very limited academic literature on the principles involved or the effects of such changes. It remains to be seen whether these options will be any more adept at tackling the agency problems that have been associated with the previous regimes (particularly in terms of project management and subsidy levels).

Nonetheless, there may be considerable scope for a convergence of the "public interest"/"mutual" models from developed countries seeking to overcome some of the problems of privatisation (Mayo and Moore 2001), and the cooperative/community development models from developing countries normally applied to questions of rural development, e.g. marketing cooperatives (APO 2002). Of course such activities are on very different scales: "mutualisation" is being considered for highly capital intensive but largely established infrastructure industries whereas "cooperative" models have generally been on a much smaller scale. Yet at the level of local infrastructures there may be some possibilities for combining approaches even though the available literatures are for the most part focused upon their own concerns, priorities and perspectives. That said, there is a limited literature looking at community or cooperative initiatives for infrastructure in developing countries. A particular focus of interest is the extension of the Grameen Bank system - initiated in Bangladesh as a largely 'self-help' mechanism for extending credit to poor farmers - to the provision of telecom services in rural areas (Bayes et al 1999; Chowdury 2000). Other examples include the involvement of community groups in the development of waste management programmes, again in Bangladesh (Pargal et al 2000) and rural electrification projects in India (APO 2002). There has also been some

experience of using not for profit enterprises to provide limited infrastructure services, e.g. AGETIPs or Executive Agencies for Public Works and Employment (World Bank, 1999). While categories such as "mutualisation" and "public interest" do not figure in their analyses, such projects have been discussed in World Bank documentation, notably recent and forthcoming World Development Reports (World Bank 2000 and 2002)

It is, however, clear that such models require considerable underpinning of state and societal structures. It is not clear whether such mechanisms could be adopted in all developing and transition economies given that they rely on extensive administrative, legal and financial infrastructures to establish the framework for their operation and to maintain their independence. Just as important as these institutional questions are the social preconditions, particularly the presence of "social capital". (Pargal et al 2000; Evans 1997 more generally on "state-society synergies").

## CONCLUSION

The literature surveyed above has generally seen privatisation as a positive development though in some respects (economic growth), it is not evident that the optimism of the researchers is wholly justified. It is clear that institutional conditions both in terms of the overall framework for doing business and the specificities of regulatory regimes and corporate governance are important conditioning factors affecting whether or not privatisation is feasible. To the extent that privatisation is deemed to be impracticable there are alternatives, but the more established mechanisms have not yielded positive results or innovations that are under way are at too early a stage to assess.

The lack of interactive dialogue between proponents and opponents of privatisation suggest future research could usefully bring these opposing approaches together to assess each others' arguments and move the debate forward. Critics of privatisation should endeavour to test the claims of supporters and/or to engage in more detailed economic analysis of the policy. Other areas where more research would be useful include examining the reasons why privatisation has been relatively less effective in low income countries; evaluations of the effectiveness of regulatory institutions in post privatised environments; more research on the impact of 'corporatisation' and on the applicability of 'not for profit' models in developing country contexts.

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# PRIVATISATION IN ROMANIA

## LEGISLATION AND METHODS

From the outset, the Romanian government excluded a large number of firms from its privatisation plans. A law passed in 1990 (Law 15/1990) by the post-Communist government divided all state-owned enterprises (SOEs) into commercial firms and 'autonomous' firms, or 'regies autonomes'. The regies autonomes were declared non-privatisable. Moreover, they were entitled to budget subsidies, exempted from the risk of bankruptcy by law, and not required to respond to claims by private creditors. According to the law, a company in any sector deemed of strategic importance to the national economy could be declared a regie autonome. However, the definition of 'strategic' was so broad as to allow the government enormous discretion in retaining a company in state ownership. Thus, 47% of state-owned capital was put off limits for privatisation, including assets in a broad range of sectors: armaments, energy, mining, postal services and railway transportation. The law was used to set up regies in sectors such as tobacco, publishing and horse breeding where the only 'rationale' for continued state ownership appears to have been the protection of vested interests (Negrescu, 2000). Only in 1997 was legislation passed to reintegrate the regies autonomes into the privatisation process. Even then, a number of regies were exempted from corporatisation. Others were converted into joint stock companies, had their natural monopolies broken up and were eventually sold.

The legislative basis for the privatisation of the remaining SOEs, known as 'commercial companies', was established at the very start of the transition process, although Romania's legislation regarding privatisation has been continuously amended since. There have been several major stages:

- In 1990, a State Ownership Fund (SOF) and five Private Ownership Funds (POFs) were established. When the commercial companies were turned into joint stock companies, 70% of their capital was placed in the SOF, and 30% in one or another of the POFs. The initial plan was that the POFs' capital would be distributed to the public, in exchange for free vouchers issued to citizens, while the SOF would sell its shares, as well as overseeing the whole process.

- In 1991, the main law on privatisation (Law 58/1991) was passed. This law established several possible methods of privatisation, including auctions and tenders, IPOs, voucher distribution to citizens, and management-employee buyouts (MEBOs). However, MEBOs emerged as the main method of privatisation.

- In 1994, with advice from the IMF, a 'mass privatisation programme' (MPP) was set up with the intention of covering one-half of industrial enterprises remaining in state ownership.

- In 1997, a new privatisation law was passed which allowed for case-by-case sales of large enterprises. This was facilitated by the law allowing some regies autonomes to be corporatised and privatised and by the liberalisation of the utilities sectors.

- Over 1997-99, small but significant amendments to the privatisation law were repeatedly enacted, creating considerable uncertainty.

- In 2001, a new privatisation agency, APAPS, was established to accelerate the privatisation of large SOEs.

## Main Methods and Objectives

The choice of methods of privatisation reflected the political priorities of Romanian governments, and affected the outcome:

**1. <u>Management-employee buyouts (MEBOs).</u>** The MEBO method essentially gives away state assets, free of charge, to a firm's employees and management. In Romania, it became the dominant form of privatisation in the early transition period, probably for three reasons:

- It was very popular with the public, who saw the method as offering protection for their jobs by contrast to other methods -- such as auctions and sales to foreign investors -- which could threaten their livelihoods.

- The method also favoured the management of the SOEs involved, thus cementing political connections among managers and government members. In this way, MEBOs helped to protect corrupt managers who stole money from the SOEs (often in alliance with the politicians who appointed them).

- Direct sales of small companies attracted little interest from local or foreign investors, so there appeared to be no alternative.

The MEBO method granted insiders -- employees and managers -- the right to acquire the 30% of each company held by POFs, in exchange for certificates of ownership. In addition, the SOF was obliged to grant extremely favourable payment terms to insiders for the purchase of extra shares: long-term payment schedules at fixed annual interest rates of 10-15% (at a time of two-digit inflation).

One advantage of the MEBO method is that it may increase support for restructuring among employees and management. Workers who might otherwise be opposed to changing production methods gain an interest in increasing productivity. This factor is of potentially great significance in Romania, where workers' unions are strong and indeed proved to be a major obstacle to reforms in the late 1990s. However, the employees'/owners' enthusiasm for change tends to be rather limited, given the controversial nature of most restructuring decisions, which generally require significant redundancies and hit one part of a firm harder than others. Moreover, managers and employees may lack the necessary skills to restructure a failing firm.

The MEBO method is criticised for its tendency to maximise income per worker rather than a firm's long-term profitability. By granting privileges to insiders, the method effectively crowds out other potential buyers for the enterprise, thereby preventing any injection of new capital or know-how. In Romania, MEBOs were especially restrictive, since there was a legal requirement that employees establish an association to hold the shares and exercise ownership rights during the three-to-five year payment period. At this time, unpaid shares could not be resold; hence there was limited scope for takeovers or concentration of ownership among a smaller group of insiders. Unlike in other Central and East European countries where MEBOs were carried out, in Romania the result was really employee ownership. Since employees and managers in Romania rarely had the capacity to invest in the firms they acquired (Negrescu, 2000), even if there was a will to restructure, the company's post-privatisation performance generally suffered from a lack of new capital. Moreover, the incentive problems associated with insider control of a troubled firm meant that it was difficult to convince lenders -- which were in any case in a poor state in Romania -- to provide credits to finance investment.

Insider privatisation has some inherent flaws. The process transfers ownership from public to private hands, but without -- by definition -- provoking a change in the management or labour force. The incentives for those running the company are changed somewhat, since they are now more motivated

to earn a profit. However, if the company is already loss-making or if the market is not competitive, these incentives alone are unlikely to bring about improvements in productivity or profitability. Rather, the insiders seek to protect their assets and conserve past production processes. At the worst extreme, MEBOs put the managers in a strong position to strip the assets of a company.

**2. Mass privatisation programme (MPP).** The poor results of the privatisation programme in the first few years prompted a change of approach, supported by the IMF, in 1994-95. The new emphasis was on mass privatisation proper, with the Fund promoting the distribution of shares to citizens so as to accomplish a mass transfer of ownership from the state to the private sector in a short period of time. Thus, new vouchers were issued and citizens encouraged to exchange them for shares in 4,000 targeted companies. However, a maximum of 60% of shares in companies could be put up for exchange against the coupons, and only 49% in the case of strategic firms. Thus, only one-sixth of the firms in the programme were in fact majority privatised. As a consequence, the state usually retained a majority stake, while the remainder was owned by a large group of small private owners. The SOF was also criticised for undervaluing enterprises, with some allegations of corruption in this regard. In 1997, the National Audit Commission reported that 363 of 610 companies audited had been undervalued by the SOF, although the proper procedure for valuing such companies is contested.

One advantage of MPP is that a mass transfer of ownership can occur despite low domestic savings and weak foreign investor interest (Earle and Telegdy, 2002); on the other hand, it does not bring in revenue for the state. Perhaps the greatest disadvantage is that privatisation through MPP results in a highly dispersed ownership. Such an ownership structure is a major barrier to enterprise restructuring, hence the post-privatisation performance of the firm is likely to deteriorate.

In addition, two factors specific to the Romanian process exacerbated this problem:

- The reluctance to sell a majority share in companies meant that, at the end of the process, the SOF remained in control of most of the companies in its portfolio. It still had to sell the remaining shares of each company case by case, but few investors were interested in sharing assets with numerous minority shareholders (Negrescu, 2000).

- The Romanian mass privatisation programme ensured an enduring dispersion of ownership by prohibiting trading of vouchers and the formation of intermediaries.

The possibilities for improving the performance of enterprises thus came only through secondary post-privatisation measures. At this point, shares could be traded. Hence there was a possibility to concentrate ownership, while the fluctuating share price created some pressure on managers to improve performance (Earle and Telegdy, 2002). However, secondary trading attracted very low levels of foreign portfolio investment.

**3. Direct sales.** By 1997, it had become apparent that the MPP was ineffective in promoting enterprise restructuring. Moreover, in that year, a centre-right government more inclined to implement market reforms took office. Thus, an enterprise liquidation programme began, leading to the long-overdue closure of many failing industries, including the mining sector. Many of the regies autonomes were corporatised, their industries liberalised and companies prepared for privatisation. A new privatisation law was enacted, although repeated amendments over the 1997-99 period often led to difficulties in finalising deals and ensuring that contractual commitments were fulfilled; this created an unnecessary degree of uncertainty, which deterred foreign investors and hence inhibited privatisation by direct sales. Nevertheless, large-scale privatisation finally began, with the government keen to sell to strategic investors -- not least so as to bring in hard currency to relieve a burgeoning current account deficit and support the budget. The pace of privatisation picked up dramatically. In the period 1993-96, only 83 companies defined as large had been privatised, but from 1997 to mid-1999, a further 183 were sold. The number of transactions involving foreign investors increased from eleven in 1993-96 to 201 in 1997-99 (Negrescu, 2000).

Direct sales to strategic investors are associated with the greatest post-privatisation gains in terms of enterprise restructuring. Concentrated ownership facilitates sound corporate governance and the taking of tough decisions to lay off workers, cease production of unprofitable lines, and reorient trade to new markets (see Section 2).

However, Bucharest pursued a flawed variation of this method. It selected closed-bid tenders as the primary method for executing direct sales. In this method, the SOF was responsible for selecting a buyer, apparently according to the price offered, the proposed business plan, and pledges related to investment and retaining employment etc. The system had two major problems:

- Transparency deficit. Closed-bid tenders naturally involve a lack of transparency, exacerbated by there being multiple criteria assessed in the evaluation of bids (Earle and Telegdy, 2002). In Romania, no pre-determined weights were attached to the criteria, and details of the bids were not revealed after the final decision -- leaving significant potential for corruption. At the worst extreme, the bidder and the SOF evaluator could collude to strip an enterprise's assets. More minor forms of corruption involved the paying of bribes or use of connections to SOF members to ensure that a certain bidder won, despite not offering the best price or terms. Even where explicit corruption was not a factor, the method was vulnerable to poor or politicised decisions, designed to benefit certain social groups rather than secure the best price or investment plans. In addition, the system created massive uncertainty, further deterring investors and encouraging bribe payments in an effort to increase certainty.

- Contractual restrictions. The deals often included restrictions on the buyer's post-privatisation behaviour. Sometimes the restrictions were aimed at influencing restructuring decisions -- for example, by requesting commitments to a certain level of investment, the authorities could protect against unfair practices such as where a bidder bought a firm only to immediately close it down so as to reduce competition for his own products. However, often the restrictions took the form of pledges not to make employees redundant, or at least to provide extensive compensation for any employees laid off, as well as commitments to buy from certain suppliers at fixed rates. While the latter type of restrictions softened the social costs of privatisation and hence were popular with politicians and voters, they proved a major hindrance to post-privatisation restructuring, and deterred many buyers, especially foreign investors. Moreover, even the former kind of restrictions -- investment commitments -- are now generally regarded as inadvisable.

The lack of transparency created conditions in which corruption could flourish in the privatisation process. However, the SOF also demonstrated incompetence, not necessarily associated with deliberate corruption. For example, when seeking to privatise the Petromidia oil refinery in 1998, the SOF's negotiations with a US consortium became extremely protracted as the SOF repeatedly changed its priorities with regard to price and investment commitments. Such experience led to the increasing use of international investment banks to mediate sales, although problems then arose over the SOF's commission payments to the banks.

In 1997, 81.6% of privatisation deals were carried out through direct sales, and 65.8% of large privatisation deals in 1998. The period saw some major achievements in privatisation (OECD 2001):

- The first ex-regies autonomes were sold, including Romtelecom, the national telecoms company (purchased by Greece's OTE), the Romanian Bank for Development (sold to France's Societe Generale) and Bankpost (sold to GE Capital and Banco Portugues de Investimento). This also reduced the SOF's dominance over the process, since the privatisation of most national monopolies was the responsibility of the ministries, not the SOF.

- The large assets on offer attracted foreign investors, bringing significant foreign capital, know-how and technology to Romania for the first time in the transition period -- 2 billion dollars in 1998 alone.

- Sales on capital markets began to pick up, boosting financial market activity, although this method was used mainly for residual shares left over after the MPP.

Nevertheless, the state's share in industrial companies remained on average 36% at the end of 1998 and the SOF held a share of some size in more than 75% of firms. Most companies with any private ownership were majority private, but employees and MPP participants were major owners.

In early 2001, a leftist government took office and transformed the SOF into a new privatisation agency, APAPS, charged with accelerating the privatisation of the 1,135 companies in its portfolio -- particularly, the remaining large assets. Despite its leftist credentials, the government claims to be committed to pursuing market reforms and taking advice from the IMF and World Bank. Since coming to power, the government has sold (to foreign investors) Romania's largest steel maker Sidex and giant state bank, Banca Agricola. In cooperation with the World Bank, a further 64 firms have been selected for rapid privatisation. These include the national airline Tarom (which must first undergo reorganisation), aluminium smelter Alro, Banca Comerciala Romana and Antibiotice, a pharmaceuticals firm.

The largest upcoming sale, that of BCR, which owns one-third of the country's banking assets and has 3 million customers as well as a reputation for sound management, appears to offer promising opportunities. Valued at 1.5 billion dollars, BCR was promoted as Europe's largest privatisation in 2002. Dutch bank ING initially showed keen interest. However, the global economic downturn frightened off major investors and the Romanian government rejected those remaining in the field as unsuitable. The IMF has said it will pay 'special attention' to the BCR sale, potentially refusing to disburse the next instalment of the standby loan until this is completed. The selection of fresh bids is to be completed by next February with the sale due to be finalised by August.

**4. IPOs.** Privatisation through capital markets has not been a success in Romania. Although there were no legislative barriers to using this method, other reasons may have prevented it from being used:

- The poor state of financial market institutions and lack of credibility of the Romanian markets created great uncertainty as to the security of investments, deterring foreign portfolio investors and meaning that there was little demand for such investments.

- Foreign investors operating in an uncertain environment generally prefer direct negotiations with the government, allowing them greater influence over the terms and greater certainty about the size of stake they will be able to acquire.

- The IPO approach may not have been preferred by the authorities, since it allowed little control over the choice of private owners. Other aspects of the privatisation programme suggest that the authorities favoured methods allowing them to influence the final ownership of companies.

Indeed, this method was mainly used to supplement others -- investors who purchased a stake through a direct sale later also purchased shares listed on the Bucharest Stock Exchange.

## THE IMPACT OF PRIVATISATION

It is difficult to isolate the effects of privatisation per se in an economy undergoing a massive political and economic transition. However, a number of observations may be made about the impact of privatisation on macroeconomic performance, enterprise restructuring, FDI levels and, in the case of public utilities, on services delivery:

**1. Macroeconomic impact.** Privatisation in general is strongly correlated with higher real GDP growth and lower unemployment, given a six to eighteen month lag (see, for example, Barnett, 2000). While there appear to be no estimates of the impact of privatisation as an isolated factor on GDP growth in Romania, we can see that the Romanian economy started to see sustained growth only after the wave of direct sales (GDP growth was 1.8% in 2000 and 5.3% in 2001, following contraction in 1997-99). This supports our expectation that there should be a positive relationship between enterprise restructuring -- as a result of privatisation to strategic investors, among other factors -- and GDP growth. Hence the section on enterprise productivity and restructuring below sheds most light on the likely impact of privatisation on GDP growth.

Privatisation's most direct and immediate macroeconomic impact is on the budget. Governments are often attracted to the direct sale method, for example, because it represents the most reliable method for maximising revenues from a given sale. Governments with large budget deficits can in this way be motivated to sell large, even majority stakes, particularly when under pressure from BWIs to keep budget deficits low. However, Barnett (2000) finds that, in general, privatisation proceeds are used to reduce domestic financing rather than to finance larger deficits.

Direct sales to foreign investors also bring in foreign currency and help to relieve balance of payments deficits. This was a key incentive for the Romanian government during the period 1997-99 when the foreign debt burden was extremely high. In 1999 alone, Romania had to meet debt service obligations totalling 3 billion dollars; privatisation revenues of around 1.2 billion dollars that year were a significant help. Reliance on IMF support during this period -- both directly in the form of credits and indirectly since the Fund's vote of confidence kept rates lower for borrowing on international markets -- also motivated the government to keep the budget deficit within agreed targets and to keep up the privatisation programme.

However, FDI was rarely a major source of capital inflows. Moreover, the impact on the balance of payments is not straightforward: foreign investors -- especially where they are granted market advantages in the initial privatisation negotiations -- subsequently repatriate their profits and pay high wages to expatriate employees, leading to high capital outflows (Voinea 2001). The export-oriented FDI that flowed into Romania in the late 1990s led to impressive export growth from around 2000, but the same companies also relied heavily on imported inputs (for 100% of inputs in some cases). Hence the overall impact was in fact to increase the trade deficit. Romanian exports have grown in recent years, but largely as a result of these low value-added labour-intensive industries: clothing, footwear and furniture account for 40% of total exports. Much of this constitutes re-exports under outward-processing arrangements.

**2. Productivity and restructuring of enterprises.** The OECD (2001) finds that restructuring in Romanian firms has been slowest in companies controlled by employees and most effective in companies controlled by foreign strategic investors. This echoes a widely accepted argument that a sole investor can run a firm more efficiently than a fragmented ownership of employees, managers and/or citizen shareholders (see also Djankov and Murrell 2000). Foreign investors also tend to bring added know-how and technology, and to run the firm more efficiently than a local investor (who is more likely to have political connections and seek to protect vested interests).

Pohl et al. (1997), in their analysis of the financial and operating data of 6,300 firms in seven East European countries, agree that firms with concentrated ownership tend to restructure more than firms with dispersed ownership. However, they also find that case-by-case privatisation does not, on average, lead to greater productivity improvements than mass privatisation. They argue that mass privatisation does not always result in dispersed ownership; rather, ownership often becomes concentrated in the hands of large investment funds or holding companies. In other words, the best method is the one that leads to concentrated ownership -- and this can, as shown in some East European countries, include mass privatisation schemes. However, for reasons discussed in the previous section, mass privatisation in Romania did not lead to concentrated ownership and hence did not allow the associated restructuring benefits.

Pohl et al.'s analysis does shed light on how non-transparent procedures can hinder restructuring for highly indebted companies. This is relevant for Romania, where 62% of industrial firms were unable to service their debts in 1992 (still 60% in 1995). Pohl et al. find that in the early days of transition, bank loans and debt write-offs for failing companies did not help to restructure firms, but rather financed their losses. By 1995, this had changed, with banks in five out of the seven East European countries helping firms to make sound business decisions and supporting their restructuring. The two exceptions were Bulgaria and Romania, where little progress had been made in privatising banks, introducing sound lending policies or enforcing hard budget constraints. This demonstrates the importance of restructuring and privatisation in the banking sector as a precondition for industrial privatisation. Failure to simultaneously break down connections between business and politics allows firms with close political connections to the state or banks to continue to be sheltered from the rigours of financial discipline. Foreign investment is generally assumed to promote restructuring more than local investment. However, foreign investors are interested in only a limited range of SOEs -- generally large firms with relatively developed markets. Hence, Pohl et al.'s finding that firms in a competitive environment are adept at restructuring themselves even without foreign assistance makes an important contribution to the privatisation-restructuring debate. They argue that the critical factors for restructuring are the will to shed labour and the creativity and human capital to seek new Western markets, develop new products and improve quality. Firms which allow real wages to grow slower than labour productivity can invest more, further accelerating subsequent productivity gains. The implication is that MEBOs -- which tend to create post-privatisation opposition to real wage cuts and redundancies while failing to bring in new capital or know-how -- are least likely to lead to restructuring. This is confirmed by primary research: a study of 645 companies privatised through MEBOs (around 80% of total MEBOs up to 1994) indicates that their profitability in the first two years after privatisation declined significantly, from 7.3% in 1994 to 2.2% in 1997, while indebtedness increased from 29.3% to 48.5% in the same period (Negrescu, 2000).

Almos and Telegdy (2002) also find that privatisation's positive effect on labour productivity in Romanian firms is greatest where the new owners are external holders (ie. not employees or managers) of block stakes, though they also find that disaggregated private owners improve labour productivity relative to continued state ownership. Almos and Telegdy find that privatised companies often suffer from corporate governance problems in Romania, as a result of conflict between controlling owners and minority shareholders. This is because the latter tend to have gained their shares through the MPP and hence the controlling owner does not regard them as true investors. However, in many cases, majority shareholders have successfully bought out minority shareholders, and later de-listed the companies from the stock exchange.

Government policies to assist with financial restructuring generally do not create the right incentives for subsequent company restructuring (Pohl et al. 2000; Djankov and Ilayperuma 1997). If the government bales out a company, that company has little incentive to alter its structure and become more competitive. Rather, it can assume that if it runs into financial troubles again, the government will help out again. This is the core of the problem. Governments would be better refraining from recapitalising banks until privatisation and restructuring have led to productivity gains in the real

economy. This allows firms to pay off some of their debts to the banks, reducing the overall burden on the government to cover bad debts. Banks should be recapitalised as part of their privatisation.

Privatisation to date has mainly benefited labour-intensive industries, and FDI has mainly been attracted to these areas. Thus the overall process has contributed to maintaining high demand for low-wage workers, thus keeping wages low. Where privatisation has led to restructuring of companies, this has often involved laying off many workers, and this has also kept wages low and supply of labour plentiful. On the other hand, the early phase of privatisation, relying heavily on MEBOs, allowed the new managers to increase their own wages. In addition, the privatisation of some heavily unionised sectors has been so controversial that it has prompted union outcry; since the government generally has caved in to such pressure, this has also had the effect of increasing wages.

**3. Foreign direct investment.** The first years of transition in Romania saw very weak foreign investment inflows, with Romania receiving only 5% of the total FDI into Central and Eastern Europe (compared with 37% for Hungary and 20% for Poland). This partly reflected the predominance of the MEBO and MPP methods of privatisation, creating few opportunities for FDI. The privatisation process accounted for only around 15% of total foreign investment (FDI and portfolio investment) in Romania over 1991-96. Firms privatised through MEBOs found it difficult to attract foreign capital even after privatisation, because investors were put off by the ownership structure or uncertain business climate. Similarly, the MPP hindered post-privatisation consolidation of ownership, while trading of vouchers prior to and during the sale was carried out only on the black market -- to which foreigners had little access. It was not simply the privatisation methods which deterred investors, but also the overall business environment. Most potential greenfield investors were deterred by high administrative barriers, legislative uncertainty and the prospect of competing with local firms operating under soft budget constraints.

However, the statistics in this area should be interpreted carefully. While the data show that 80% of FDI in Romania to date is greenfield, a closer look at the definition of greenfield investment reveals that it includes second-wave capital flows associated with privatisation and investment commitments agreed upon in privatisation contracts. Moreover, reinvested profits are not counted as foreign investment at all (Voinea 2002). Other sources estimate the share of privatisation-related flows in total FDI at around 50% (Hunya 2000).

Once the government began to offer SOEs through direct sales in 1997, the pace of FDI inflows into Romania picked up rapidly. FDI inflows of around 1 billion dollars per year were seen in 1999, 2000 and 2001, with France, Germany, South Korea, the Netherlands and the United States the top five sources of the current FDI stock. However, this FDI was not the best type for promoting economic restructuring and modernisation. FDI was attracted largely by low wages, and apparently not with the intention of selling to the local market (purchasing power was decreasing at this time owing to recession). FDI thus focused on labour-intensive and export-oriented sectors and did not much help to change the fundamental structure of the Romanian economy or its trade patterns (Voinea 2002).

A serious flaw in the Romanian system of direct sales was the lack of transparency in the negotiations process. This seems to have led to many buyers securing deals which allowed them to act in an anti-competitive manner after privatisation. For example, OTE gained a five-year monopoly over the fixed-line telecoms market when it bought Romtelecom in 1998. Such barriers to entry may have deterred subsequent capital inflows, and certainly create conditions where there is little competitive pressure towards technological or productivity improvements (Voinea, 2002).

Privatisation also brought in investment through the commitments made by buyers at the time of purchase. However, the government did not establish explicit mechanisms for monitoring whether investment commitments were realised. Any policing of this activity relied upon the judicial system, where lengthy delays and corruption hindered the efficiency of such cases.

**4. Service delivery.** Many public utilities in Romania remain in state ownership, undergoing the final stages of liberalisation and restructuring, and hence there is little evidence concerning the impact of privatisation on service delivery in the utilities. Electricity generation, transmission and distribution facilities are still state-owned, as are natural gas and water companies and the post office. However, all public utilities and restructured state monopolies -- not including 'strategic' firms such as arms producers -- are now slated for privatisation by the end of 2003.

The main utility privatisation which has been completed -- that of Romtelecom -- suggests that greater attention should be paid in future to the post-privatisation impact on market conditions and consumer services. The deal to sell Romtelecom to Greece's OTE appears to have been designed to OTE's great advantage and to the consumer's disadvantage. OTE was granted a fixed-line monopoly position for five years, during which prices for phone calls increased rapidly, apparently well beyond rates in other European countries. The fixed-line telecoms network will only be fully liberalised in January 2003.

The privatisation of Romtelecom has resulted in very little restructuring, for two main reasons:

- The state retained a 65% stake, hence foreign investor OTE was unable to force through its plans for a radical restructuring of the firm. OTE's efforts to increase its stake have also been delayed by lengthy negotiations between the two owners during 2002.

- Romtelecom's fixed-line monopoly is still in place, with the market set for liberalisation only in January 2003. Thus the threat of competition has not motivated restructuring.

Overall, the privatisation of Romtelecom has had very little impact on prices, quality of services or the labour force. However, on November 26, OTE and the Romanian government were reported to have come to a deal on a recapitalisation of the company which will allow OTE to increase its stake. Details of the deal were not published. OTE will likely pursue a cost-cutting campaign once it has control of the company, and may begin to invest more enthusiastically, although the company's weakening financial position may limit this. The investor appears averse to price cuts, having complained bitterly about the regulator's plan to reduce tariffs by an average of 30%. OTE's refusal to announce the terms of the deal suggests that it has been unable to negotiate a relaxation of this planned price cut. Overall, then, it is the liberalisation of the market, rather than privatisation of the main utility, which is likely to bring efficiency gains and price cuts to Romanian telecoms.

## CONCLUSION

The main reasons why BWIs recommend that transition economies undergo privatisation -- to promote enterprise restructuring and introduce competition to uncompetitive markets -- appear not to have been the primary motivations of the Romanian policy-makers who executed the programme. The choice of methods for privatisation in the early years led to dispersed ownership as well as weak incentives and capacity for restructuring among the new owners. The subsequent shift to direct sales brought significant achievements in terms of selling large firms and attracting FDI. However, operating in highly non-transparent conditions, policy-makers often designed the terms of the contract such that the new buyer faced weak competitive pressures after privatisation, and hence was not motivated to undertake significant restructuring. The literature on privatisation in Romania strongly indicates that both the choice of method and the way in which it is executed are critical to the impact of privatisation. Proper execution of privatisation programmes in turn appears to require a capable and ethical bureaucracy and political leadership; research on this aspect of the process is scarce.

## FURTHER RESEARCH

There seem to be five main avenues for further research, which are not covered in depth in the existing literature:

**1. Institutional basis.** There is little analysis of the institutional framework and transparency of the procedures used for privatising assets in Romania. Such research would need to look at a number of elements:

- The roles and responsibilities of actors involved in privatisation – e.g. the SOF, the POFs, and the ministries. It should look not just at the formal and legal roles, but also at how functions were performed in practice.
- The transparency of methods used, or, conversely, any ambiguities leaving scope for corruption. This might include analysis of the standards of conduct of public servants employed in the process, and at the efficacy of efforts to introduce ethical guidelines.
- The aim of this analysis would be to facilitate understanding of whether weak or incompetent institutions led to inefficiency and corruption in the privatisation process.

**2. Utilities privatisation.** The poor progress of the privatisation of utilities in Romania is one clear reason why there is little research evaluating the process or the impact on service delivery. However, research could nevertheless be carried out on the performance of the utilities in the first ten years of privatisation, since some have undergone restructuring at various points, and some, namely telecommunications, have been privatised. Such research would thus provide a basis for analysing whether restructuring is possible and effective without privatisation.

**3. Black market operations.** Black-market trading of vouchers appears to have played an important role in the process of transferring ownership from public to private hands. Further research into the trends in this behaviour would facilitate understanding of the demand for privatised company stakes, as well as of ways to prevent such illegal activity.

**4. Inequality, poverty and wage effects.** There appears to be no research on the impact of privatisation on wages, poverty or inequality. Such research would be difficult to carry out on a macro basis, since the privatisation process was so prolonged and occurred at the same time as other major changes in economic policy in Romania. Hence, isolating the effect of privatisation per se would be difficult, unless looking at the impact on wages of the privatisation of particular enterprises. The latter approach would be possible and could provide valuable information as to the wage decisions of new managers and owners.

**5. SOE subsidies.** No research on the issue of the extent to which privatisation allowed for the reduction of subsidies to formerly state-owned enterprises has been found. One could speculate that, in some cases, large firms remained reliant -- in practical terms -- on continued government support, e.g. through accumulating payment arrears to state suppliers and relying ultimately on state support if bankruptcy approached. However, far deeper research would be necessary to assess this fully.

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# PRIVATISATION IN RUSSIA

## LEGISLATION AND METHODS

The privatisation of former state enterprises in Russia, as in other post-socialist states, has -- in principle, at least -- intended to achieve a number of objectives. Broadly speaking, these can be grouped under four headings:

**1. Restructuring and investment.** The overriding aim of privatisation has been to promote efficiency by creating an incentives-based economy. Over the long term, realisation of the putative economic benefits of privatisation requires that enterprises pass into the control of owners who have both the means and the incentives to restructure their activities and to invest in their development.

**2. Entrenchment of reforms.** Reformers anxious to ensure that the market transformation does not stall owing to a backlash against reform have had two priorities -- equity and speed:

- The initial assignment of property rights is a one-off exercise whose outcome will substantially shape the economic and political fortunes of individuals and social groups for the indefinite future. The legitimacy of the new political and economic order thus depends to a great extent on the perceived legitimacy of the privatisation process. The mechanisms by which assets are privatised and the resulting distribution must be generally accepted as fair. Equity is especially important in a country such as Russia, where there was far more genuine popular support for state socialism, even at the end of the Soviet period, than was the case in some of the Central European states, where the old system was widely regarded as an alien imposition.

- The reformers' early emphasis on the speed of privatisation reflected the desire -- arguably an imperative -- to use privatisation to build support for reforms, creating a new class of asset owners with a stake in the new system. There was a widespread conviction that the 'extraordinary politics' of the initial post-communist period could not last and that the reformers must take all possible steps to make reforms irreversible before the expected anti-reform backlash caused the reform process to stall. The pain of reforms meant that such a backlash was believed to be inevitable at some point. Yet while this desire to press ahead as far as possible given the 'window of opportunity' that opened for reform when the Soviet Union collapsed is understandable, one must question this emphasis on speed as a criterion of success. In view of the major complexity of the process and the enormity of the stakes, the notion of speed as a criterion of privatisation success looks inappropriate.

**3. Fiscal relief.** While more attention has focused on the potential (or lack thereof) of privatisation as a source of revenue for cash-strapped state budgets, privatisation is also seen as a means of reducing expenditures by cutting ailing firms off from the state budget and thereby compelling them to survive on their own or face bankruptcy. Fortescue (2001) regards shedding the burden of what were reckoned to be hopelessly non-viable enterprises to have been one of the major motives underlying early rapid-privatisation policies in Russia.

**4. Social objectives.** The above considerations are often balanced against social policy objectives, such as job preservation or the resolution of environmental problems by the new owners.

Clearly, many of these objectives are in tension with one another. If speed is given priority, equity may suffer and revenue-raising certainly will. Rapid sales will tend to depress prices because too many assets hit the market too quickly (and demand will be limited if attempts are made to prevent too much foreign participation) and because enterprises are sold in an unrestructured state. However,

the state budget may still benefit if rapid privatisation reduces expenditure. Thus, the revenue losses from speedy sales must be set against the costs of retaining enterprises in the state sector for a longer period. Governments must decide whether to restructure firms and then privatise them (maximising sale prices) or to privatise first and leave restructuring (and its associated costs) to the new owners and the market. An emphasis on equity will reduce both privatisation revenues and the prospects for transferring assets to owners with the means and motivation to restructure and invest. Revenue-raising and social objectives, too, are in obvious tension: sale prices will fall as employment preservation conditions and other social 'strings' are attached. It is hardly surprising, therefore, that privatisation policies in all post-communist states have involved a variety of methods, as policy-makers sought to juggle these different goals.

## Privatisation Context

Any assessment of Russia's privatisation experience must begin with an appreciation of the context in which privatisation policies were formulated and implemented. The most important point is that Russian privatisation was undertaken in extremely inauspicious circumstances and that its development owed far more to ad hoc political manoeuvring than to any more or less coherent plan. The whole process was launched in 1992 in the midst of a deep economic and political crisis -- the Soviet state had just collapsed and the economy had been in virtual free-fall from early 1991, with output falling by around 12-13% in real terms and inflation rapidly increasing. However, it was not merely the immediate political or economic conjuncture that so handicapped the reformers. The real problems were structural:

1. The structural distortions of the economy inherited by Russia's radical reformers more or less guaranteed that the market transition would be both more complex and more painful than it was in the more advanced transition economies of Central Europe. These distortions were not wholly dissimilar to those which afflicted other post-communist economies, but they were arguably greater in the Soviet case than elsewhere. This is partly because central planning prevailed longer in the Soviet Union than elsewhere, but also because so much of the Soviet Union's basic industrialisation took place under central planning. Planners did not merely deform an existing industrial structure; to a great extent, they created one from scratch, and they did so on the basis of a set of priorities that do not in any way reflect the economic structure Russia requires if it is to integrate itself successfully with the world economy. The resulting industrial structure was almost comically inefficient in its use of resources and heavily oriented towards the defence and heavy industrial priorities of Soviet leaders.

2. The other great structural handicap, which perhaps more than any other defined the nature of Russian reforms after 1991, was state weakness. McFaul (1997) has identified three criteria of state strength: the internal cohesiveness, both ideological and institutional, of the state; the relative autonomy of the state from society (i.e. the degree to which state structures are or are not captive to particular interests); and the ability of the state to implement policy effectively. On all three counts, he finds the post-Soviet Russian state exceptionally weak. In January 1992, it still lacked many of the attributes conventionally associated with statehood. It had neither its own currency nor its own armed forces, it did not control its borders, and it was unable to perform such basic functions as tax collection. Sub-national governments openly defied the centre, while central bureaucracies were in turmoil. The planning and control apparatuses of the old system were already in an advanced state of disintegration by the end of 1991 and nothing had yet arisen to take their place. The governments of the 1990s, thus, rested on the slenderest of political bases and presided over an administrative structure that was at best ineffective and at worst obstructionist.

With respect to privatisation, in particular, state weakness was already manifesting itself in the process of 'spontaneous' privatisation that was already well under way by the time of the Soviet collapse, as managers siphoned off assets into private companies (Nolan, 1995; Solnick, 1999).

Regaining a measure of control over the process of ownership transformation was a major goal of the mass privatisation programme initiated in 1992.

It is important to note that the political struggles over privatisation served to weaken the state further during the 1990s (Ganev, 2000). The principal concern of the new elite that had taken control of the state at the beginning of the 1990s was the distribution of state assets via (formal or informal) privatisation. When the dominant project of the ruling elite is not to use the state to pursue some other ends (war-making, the extraction of resources from civil society etc.) but rather to extract assets from the state, then it is in the elite's own interest to weaken the state still further, at least in the short term. Only when the scramble for assets is over and the new owners have turned their attention to protecting their newly won property rights do they turn their attention to strengthening the state -- as the Russian elite has done in the transition from former President Boris Yeltsin to President Vladimir Putin.

In the final analysis, the privatisation mechanisms employed in the 1990s reflected the government's weakness more than its radical ambitions. Unable to force through its preferred privatisation policies, it cut a deal with the managerial elite in an effort to shore up support for itself and begin creating a social base for reforms. Thereafter, it did further deals with the so-called 'oligarchs' who came to prominence in the mid-1990s and pushed through the scandalous 'loans-for-shares' scheme. This triumph of politics over economic rationality was probably inevitable: it is difficult to imagine a more political question than the assignment of first property rights. Political considerations can never be excluded from such a process and, where the state is weak, divided and lacking autonomy, political machinations are likely to predominate.

All this might seem to suggest that it would have been better to postpone privatisation altogether than to proceed with the schemes that were eventually implemented, particularly the hasty voucher programme of 1992-94. However, given the Russian state's track record since 1992, it is difficult to believe that it would have provided more effective ownership of Russia's capital stock or that it would have been more successful at preventing asset-stripping, capital flight and other predatory behaviours if more enterprises had remained in the state sector. A look across the border at any number of other CIS states suggests that the importance of rapid privatisation -- for good or ill -- has been grossly exaggerated. Many economies where privatisation has been much slower have experienced all the maladies that in Russia have been attributed to rapid privatisation.

## Methods of Privatisation

Numerous formal and informal mechanisms have been employed for the privatisation of state property in Russia, ranging from leased buy-outs to investment tenders. Only the most important are discussed below. The critical feature running through all of them -- and, indeed, through Russia's entire privatisation experience -- is the predominance of insider (mainly managerial but also workforce) interests. While it was insider control of the voucher phase of privatisation (see below) that attracted greatest attention, insider privatisation has tended to predominate in Russia no matter what mechanisms were used. Indeed, where privatisation has not taken place, enterprise insiders have tended to 'privatise' financial flows, siphoning funds and assets from state enterprises into vehicles they control:

**1. <u>Voucher privatisation</u>.** The first phase of privatisation of large enterprises -- those with over 1,000 employees or a book value of assets of over 50 million roubles on January 1, 1992 -- was launched in 1992 and completed in mid-1994. It began with the conversion of such enterprises into joint-stock companies with tradable shares and boards of directors. The shares were initially owned by the State Property Committee (GKI) and were divided into two tranches: 50-60% (depending on the method chosen) was to be allocated in voucher auctions open to all citizens, each of whom was to

receive a 10,000 rouble privatisation voucher to use at auction, to invest in an investment fund or simply to sell if they so wished. These proposals initially met fierce resistance, especially from Russia's powerful managerial lobby. The programme was allowed to go forward only after the menu of options available to privatising enterprises had been altered in such a way as to offer extremely favourable terms to their work collectives.

This process suffered from a number of significant problems. Nolan (1995) suggests that the following were the most important:

1. Much of the public found the entire programme incomprehensible when it was launched. The materials prepared to educate the populace at large appear to have been aimed at middle-ranking functionaries and highly educated professionals. Many ordinary Russians simply found them bewildering.

2. Managers were able to exploit their inside knowledge and positions to make the most of the concessionary terms on offer -- not least by advancing themselves loans from enterprise funds with which to add to their holdings.

3. The insider privileges were widely perceived to be unfair, as they merely reinforced the existing advantages of those managers and workers in the industrial sector who worked in more promising enterprises. Pensioners, service-sector workers, bureaucrats, members of the armed forces and other such segments of society lost out in relative terms.

4. Privatisation proceeded at the level of the enterprise or plant, with little or no prior reorganisation or restructuring. The business units so created often made little or no economic sense.

5. The initial value of assets was virtually impossible to determine in an environment of such total economic and political uncertainty. However, the informational advantages of insiders meant that they were often able to ensure the intentional undervaluation of assets they wished to acquire.

6. The fact that the programme was executed in the midst of an economic crisis created incentives for short-term behaviour -- comparable to individuals in a famine selling assets with real long-term potential very cheaply in order to meet short-term consumption needs.

As noted above, a process of spontaneous privatisation was under way by the time of the Soviet collapse, as bureaucrats and managers employed a bewildering array of schemes for transferring assets from the state enterprises and organisations they controlled into new private vehicles. Many of the apparently de novo private firms that appeared in the early 1990s were created using what were effectively stolen state assets. Rapid, large-scale privatisation was thus widely regarded by the government of Yegor Gaidar as a necessity, if only to regain a measure of control over the redistribution of state assets. There were, of course, other motives: 'mass' privatisation via a voucher scheme was supposed to enable virtually the whole of the country's adult population to become asset owners on at least a small scale. This was meant to achieve a number of the goals discussed above. Politically, it was intended to create a broad class of share owners who would support further reforms. It was also meant to cut off failing enterprises from the state budget and, ultimately, to foster the emergence of a population of real sink-or-swim firms whose managers would have incentives to use resources efficiently.

The reformers recognised that their voucher scheme would produce an economically inefficient pattern of dispersed ownership, in which enterprises were largely controlled by insiders (mainly managers) with little interest in restructuring them. However, they believed that rapid privatisation would make portfolio investment and acquisitions possible. A secondary market in corporate control would emerge and would transform the initial post-privatisation allocation of property rights into a

more efficient one, shifting control to effective owners with both the means and the inclination to restructure.

Judged against these aims, mass privatisation was not a success. It failed either to harden enterprise budget constraints or to de-politicise ownership. Insider resistance to restructuring or the loss of control to outsiders, together with the readiness of government bodies (especially regional administrations) to prop up failing enterprises, enabled many privatised firms to avoid the painful choice between restructuring and liquidation. While for example, regional administrations' controls on retail margins were applied, in principle, to all retailers, state or private. No doubt the capacity to enforce them was greater for state-owned stores. The transition from voucher privatisation to the market-driven secondary reallocation of ownership largely failed to occur, chiefly because Russia lacked the sort of institutions that might resolve, or at least ameliorate, the corporate governance problems created by the initial pattern of insider control. Instead of creating a mass pro-reform constituency, voucher privatisation benefited only a small minority of the population and largely discredited the idea of privatisation in the eyes of the general public -- a process that was completed by the scandalous loans-for-shares deals of the mid-1990s (see below). Numerous critics of the process concluded by the late 1990s that voucher privatisation had been an entirely predictable economic disaster, born of the rejection of standard 'case-by-case' methods of privatisation (Nellis, 1999). The so-called cash phase of privatisation, after the voucher privatisation ended in mid-1994, was implicitly a 'case-by-case' process.

It is difficult to exaggerate the extent to which politics drove this whole process. Few now recall that Gaidar, Anatolii Chubais and the other radical reformers in the government generally opposed voucher privatisation, preferring instead to concentrate on cash sales and on finding effective owners. Politically, however, this was untenable. The reformers inherited a 1991 privatisation law that provided for personal privatisation accounts for all adults. These were subsequently turned into tradable vouchers. Reluctantly, the government moved towards a modified version of the voucher scheme, offering important privileges to enterprise insiders, chiefly managers. This was a sine qua non of progress: if privatisation was to proceed, the government had either to defeat the insider lobbies or to appease them. Given that it was too weak to do the former, it opted for the latter course. The result was a pattern of dispersed ownership and managerial control. In the absence of hard budget constraints, effective competition and functioning capital markets, insider managers were largely able to avoid both restructuring and liquidation. In short, the concessions made to enterprise insiders in order to enable rapid privatisation to take place actually impeded post-privatisation restructuring (Roland, 1994).

In this respect, privatisation differed little from most other aspects of economic policy. In general, the governments of the 1990s succeeded in moving ahead with those strands of reform that enjoyed elite support and made only limited demands on the administrative capacities of the state. Reform policies typically failed when faced with serious resistance or the need for a strong, effective state to administer reforms. Yet this approach repeatedly led Russia into the trap of partial reform identified by Hellman (1998): incomplete early reforms created winners who resisted further reform efforts. In many cases, including privatisation, the incompleteness of the initial measures reflected the need to appease powerful interests that might otherwise block reform altogether. Thus, the bargains struck to overcome ex ante constraints on reform often made the ex post constraints worse.

Nevertheless, one should not overlook the fact that the voucher programme, which many observers -- and much of the Russian public -- had believed would come to nothing, did bring about a massive change in the structure of ownership. When the voucher process ended in 1994, some 40 million Russians had become shareholders, most of them having acquired stakes in the firms in which they worked. In the end, around 95% of the 148 million vouchers issued were used, either directly or through investment funds or via sales to other individuals. Some 85,000 small and 12-14,000 medium and large enterprises were in mainly private hands. The state's average holding had fallen to 38% across all industrial firms (including those not privatised at all to mid-1994) and an average of just

15% in privatised enterprises. According to Goskomstat data, 76% of the workforce was employed in privatised or new private firms and the bulk of GDP consisted of private-sector output. Restructuring, however, was slow, mainly because of insider control, dispersed share ownership and the dearth of outsiders able to act as real owners (see below).

Moreover, reliance on the voucher method and the extension of considerable concessions to enterprise work collectives enabled the government to execute the first phase of privatisation without too much conflict; polls in mid-1994 suggested that public support for the programme actually rose in its final months to over 60% -- although it should be noted that support then eroded again as the conflicts and scandals surrounding subsequent privatisations unfolded. Finally, there has been increasing evidence that privatisation has brought improvements in the performance of enterprises privatised to insiders during the voucher phase, although this improvement has taken far longer than it might have done had another model of privatisation been chosen (see below). Indeed, for all the opprobrium heaped on the voucher programme, Shleifer and Treisman (2000) report that they 'have been unable to find a single study that does not show positive effects of privatisation on restructuring in Russia'. This is not an exaggeration: while studies vary widely in their assessments of the extent and speed of change, virtually all post-privatisation studies of Russian enterprises show evidence of improved performance in enterprises after privatisation.

**2. Small-scale privatisation.** Small and medium-scale non-farm enterprises were disposed of by auction or through sales by tender. Small enterprises were officially defined as those with a labour force of under 200 and a book value of assets of less than 1 million roubles on January 1, 1992; the corresponding figures for medium-sized enterprises were 200-1,000 workers or a book value of 1-50 million roubles.

The management of the divestment of these assets was for the most part left to regional and local governments, which had owned the bulk of these enterprises prior to privatisation. In general, enterprise work collectives enjoyed substantial concessions in acquiring stakes in their enterprises, including a 30% discount on the winning tender or auction bid and a period of up to three years to pay 75% of the purchase price. While around 60% of such enterprises were recorded as having been privatised by their work collectives, employees themselves in many cases were unable to afford the 25% down payment and actually served as agents for managers or for outside investors seeking to take advantage of the generous terms offered to insiders. Few ordinary Russians were in a position to bid for stakes other than on the terms offered to work collectives, and many of the outside investors taking over small and medium enterprises appear to have been representatives of Russia's burgeoning organised crime structures.

A large part of the firms in this category consisted of shops, catering establishments and consumer-service outlets. In this sphere more than any other, competition from new private firms has been significant, and changes in performance probably owe as much to price liberalisation and competition as to ownership change, although some constraints were imposed on privatised outlets by local authorities, which often restricted the use of assets for a set period.

In a study of Russian retail outlets, Barberis et al. (1995) found that the post-privatisation performance of business units made a convincing case for the greater efficiency of private ownership. Privatised shops -- especially those with new owners -- were more likely to renovate, change suppliers and extend opening hours. Evidence of the impact of privatisation was reflected in both comparison of private and state firms in the same line of activity and in changes in individual companies' operations following privatisation. The former line of argument (comparison of state and private firms) is particularly important, since it makes it possible to isolate to some extent the impact of privatisation, as opposed to competition, on performance. Moreover, the poorer performance of state retail outlets does make sense: for a time, the state retail network was subject to centrally imposed direct controls, including a ceiling on retail gross margins. It was still affected by the discretionary continuation of food price controls in many regions into the second half of the 1990s.

Interestingly, although many state shops were acquired by work collectives (insiders), the problems associated with insider control in larger enterprises were largely absent from the retail sector, which became substantially more efficient. On the whole, the relatively small scale of operations, the rapid turnover of working capital and the presence of real competition contributed to a fairly effective process of privatisation, especially in the large cities.

**3. Loans for shares.** Critics of the mass privatisation of the early 1990s often argued for a more conventional 'case-by-case' approach to privatisation in Russia (see, for example, Nellis, 1999), which would treat enterprises individually and design specific privatisation packages for them. Unfortunately, the most famous case-by-case privatisations of the 1990s were easily the most scandalous. In 1995-97, the state transferred control over some of the country's most valuable enterprises (including several major oil companies and the non-ferrous metals giant Norilsk Nickel) to politically well-connected banks at extremely low prices. Initially, the banks accepted state shares in the companies involved as collateral for loans extended to the government in 1995. The understanding was that if the loans were not repaid by September 1, 1996, the collateral holders could realise the stakes, recouping the funds owed to them by the government and 30% of any privatisation revenues above the amount of the loan, with the state receiving the remaining 70%. It was clear all along that the state would not repay the loans by September; indeed, the 1996 budget contained no provision for this.

It was equally clear that the stakes would not be realised in a manner advantageous to the government. The auctions were conducted by the collateral holders themselves, who consistently ensured that the bidding was non-competitive and that the stakes were purchased by entities controlled by the collateral holders, at prices only slightly above the value of the loans. Thus, a 38% stake in Norilsk Nickel, to take but one example, was transferred to Oneksimbank in return for a credit of 170.1 million dollars. At the subsequent auction, controlled by Oneksimbank, the stake was sold to an Oneksimbank-controlled structure, ZAO Svift, for 236.18m Ecus. This valued Norilsk Nickel -- a company that accounted for one-third of world nickel production, 20% of world nickel exports and 40% of world platinum exports -- at just over 447.6 million dollars.

Nonetheless, it would be a mistake to view the give-away privatisations of the mid-1990s solely in terms of the banks' political muscle (Allan, 2002; Tompson, 2002b). Here, too, the power of incumbent industrial managers was an important factor and the loans-for-shares deals are perhaps better understood as a further stage in the insider privatisation process that began in the late Soviet period, even before the voucher scheme was launched. Loans-for-shares privatisations generally took place when the banks had managed to forge alliances with key industrial companies: hostile acquisitions were extremely rare and were fiercely contested. Even prior to the collateral auctions, banks had generally preferred acquiring stakes in enterprises with whose managers they had close relationships (Freinkman, 1995). Despite their enormous financial problems, the industrialists' position was far from weak. In the absence of a credible bankruptcy threat, they did not need to surrender control to outsiders simply because their finances were a mess, nor were they inclined to do so.

The vast majority of enterprises originally slated for inclusion in the infamous loans-for-shares auctions were able to lobby their way out. However, there was a renewed self-assertion on the part of the government, in the person of Chubais. When he insisted on limiting the number of hand-outs to cronies and making the Svyazinvest auction completely competitive, he was threatened by the oligarchs, and they followed through on their threats. The initial proposal for the scheme, put forward by a consortium of leading Russian banks, involved a list of some 64 enterprises. The presidential decree of August 31, 1995 included a list of 44, but within a fortnight this was reduced to 29, then 26 and, finally, by mid-October, just 16 (mainly in oil, metallurgy and river transport). In the end, only nine of the original list of 64 actually ended up on the auction block. Of these, three had the funds to secure control of their own shares, albeit in auctions that effectively excluded other participants, and

five were acquired by banks to which they had very close links. For the most part, therefore, the loans-for-shares auctions simply represented a second stage of insider privatisation. The only major exception was Norilsk Nickel. Oneksimbank acquired a controlling stake in this concern against its managers' wishes and had to fight a protracted legal, commercial and political battle to secure real control.

**4. Other sales.** The pace of privatisation has slowed markedly since 1997, for a number of reasons. First, the most attractive assets had been substantially privatised by that time. Ironically, this made privatisation of the remaining 'jewels', such as the oil companies Rosneft and Slavneft, even more difficult: the competition for the remaining prime assets was intensified. At the same time, the state was left with a large number of less attractive assets, the disposal of which would not be easy. Secondly, the privatisation scandals of 1995-97 followed by the economic and financial crises of 1997-98 and the political uncertainties of the Yeltsin succession in 1999-2000 all served to slow down the process. Politicians and officials grew more wary of being drawn into high-profile controversies, while economic circumstances made it harder to find buyers ready to pay more than a pittance.

The accession of President Vladimir Putin has brought some improvements in both investor sentiment and the state's performance in the field of privatisation but these changes are limited. Russia's privatisation record has not improved dramatically since the shares-for-loans fiascos. In principle, major sales should now take place on a transparent, competitive basis, with mechanisms designed to maximise the sale price realised by the state. However, there have been few such sales. Year after year, ambitious privatisation programmes are unveiled but not implemented, which has served to undermine the credibility of the state. Where sales have gone ahead, they have continued to be extremely controversial:

- Political wrangling and the opposition of insider managers to any sale that might pass control of their companies to unwelcome outsiders have caused repeated delays. The most notoriously 'jinxed' state-owned companies are probably Rosneft and Slavneft. Both are still predominantly state owned. The government has announced numerous plans for the disposal of each since 1997, but each time the proposals have been shelved. Slavneft may at last be sold by the end of 2002, following a highly public and scandalous control contest within the overwhelmingly state-owned company that involved the use of state and private security forces in attempts to enforce conflicting court orders -- even to the point of forcible seizures of the company's Moscow headquarters.

- While sale prices are a good deal higher than they were in the give-away deals of the shares-for-loans era, there is still a very strong sense that the winners in major privatisation competitions are pretty well determined in advance and that they tend to pay prices only slightly above the starting prices set by the authorities. Transparency and competition continue to be limited.

- In some cases, the authorities have ended up re-writing the terms of privatisation sales in the middle of the process, the most notorious examples being those of the insurer Rosgosstrakh and the oil company ONAKO. This has done little to enhance the credibility of the privatisation authorities. The on-again, off-again privatisation of the Eastern Oil Company (VNK) demonstrated that, even in the Putin era, rival commercial interests were able to turn the state privatisation bodies into instruments for attacking each other. However, the VNK scandal, while it did damage the standing of the Russian Federal Property Fund (RFFI), also demonstrated the changes that have taken place since the mid-1990s: when the scandal erupted, the RFFI responded to the complaints of the competing sides and investigated them before proceeding with the sale.

- The most lucrative privatisations have been those in which asset sales have been caught up in the conflicts between rival business clans -- which has sometimes meant that the most

'successful' (in terms of revenue) privatisation sales have also been among the most politicised. The two most striking examples of this tendency are the Svyazinvest sale of the summer of 1997 and the sale in 2001 of a stake in Kuzbassugol. Though hardly one of the most promising industrial concerns in Russia, the sale of 80% of Kuzbassugol fetched a price that valued it more highly than some of the resource giants sold off in the shares-for-loans scam of the mid-1990s. The lesson seems to be that rivalry among Russia's commercial 'oligarchs' contributes more to the success of privatisation than the competence of the privatisation authorities themselves. However, the political fallout from the Svyazinvest scandal hardly enhanced the incentives for the authorities to conduct fair, transparent sales: the Svyazinvest deal provoked a fierce battle among Russia's business clans that ultimately led to the resignation of Finance Minister Anatolii Chubais and several of his associates.

## THE IMPACT OF PRIVATISATION

Before examining specific issues pertaining to the impact of privatisation, it is crucial to 'put privatisation in its place'. The overriding lesson of the last decade has been that the significance of privatisation -- for good or ill -- was greatly exaggerated at the beginning of the market transformation. The beneficial or detrimental effects of privatisation depend hugely on context and are thus inextricably linked to changes in the wider economic environment -- and, in particular, to competition policy, changes in corporate governance, the imposition of hard budget constraints on enterprises, and the development of capital markets and other institutions favouring the emergence of a competitive, smoothly functioning market in corporate control.

Despite the obvious flaws of Russian privatisation processes, it would be a mistake to attribute too much of the blame for Russia's economic problems in the 1990s to botched privatisation. Failures with respect to other structural reforms mattered at least as much. Likewise, the benefits of privatisation that many researchers have identified largely depend on progress with respect to other factors, such as the development of competitive product markets. Thus, Angelucci et al. (2002), using data from a large enterprise-level panel designed to address the determinants of privatised enterprise performance in Russia, find strong complementarities between four factors influencing improved company performance: enterprise ownership; corporate governance; market structures and competition; and financial constraints. This confirms the view that these factors need to be considered jointly:

**1. Ownership structures and the problem of insider control.** As noted above, the structure of ownership resulting from the voucher privatisation programme was dominated by insiders (managers and work collectives). As of July 1994, managers held 19.6% of the shares in large privatised enterprises and workers 46.2%; outsiders held just 18.9% of all shares (Earle and Estrin, 1998). However, this did represent at least some erosion of insiders' advantages: the 'lease-buy-outs' which had been the principal mechanism for the spontaneous privatisations of 1990-92 left over 90% of the shares in the hands of insiders and 95% of enterprises so privatised had a dominant insider owner. Thus, the Gaidar government's aim of trying to check somewhat the unregulated privatisation of state assets into the hands of managers and officials was at least partly achieved.

Insider ownership was widely -- and rightly -- seen as a problem in the mid-1990s. The problem was not that insider ownership was necessarily a bad thing but that, in Russian conditions, it made real market-oriented restructuring less likely. Managers often found it more lucrative to concentrate on informal profit-seeking (ie. asset stripping and other forms of corruption) while workers' chief concern was job preservation.

In theory, of course, market disciplines should have compelled insiders in failing enterprises either to restructure or to surrender control to those who could and would do so. However, real market disciplines were not imposed. The readiness of the authorities to tolerate tax arrears and provide

implicit subsidies, as well as the acceptance of massive inter-enterprise arrears among linked enterprises trying to weather the transition together, meant that budget constraints often remained soft, despite the radical rhetoric of the market reformers (Tompson, 2001). All levels of government, but especially the regional authorities, continued to prop up troubled enterprises. In the absence of hard budget constraints, there was little incentive for insiders to restructure or cede any control to outsiders in return for investment or loans. At the same time, the slow development of legal and institutional frameworks to protect creditors and shareholders, to improve corporate governance and to provide the basis for a proper market in corporate control meant that it was difficult (and expensive) for outsiders to take secure control over companies even if they reached agreement with insider owners.

It would be a mistake to attribute all Russia's corporate governance problems to opportunistic insiders -- new outside owners have often been just as predatory in their methods and just as determined as insiders to drive out rival shareholders or at least check their influence. Nonetheless, the weakness of the corporate governance framework made it easier for inside owners to resist outside penetration and to abuse outside shareholders' rights when the latter did secure a foothold. All this draws attention once again to the extent to which the impact of privatisation has depended on changes in the wider institutional and economic environment.

The problems confronting outside investors are exemplified by those faced in the early 1990s by Russia's earliest 'institutional investors' -- the voucher investment funds. Frydman, Pistor and Rapaczynski (1996) analysed the performance of voucher funds on the basis of a survey of 148 of Russia's 300 or so privatisation investment funds representing, in terms of size, 69% of all investment funds created in connection with voucher privatisation. The funds surveyed held shares in about 5,000 privatised enterprises. Analysis of the survey data suggest that investment funds, like most other outside investors, had a relatively small impact on the governance of Russian firms due to predominant control by insiders, particularly management. The investment funds did attempt to influence the firms in their portfolios in a variety of ways (through obtaining board seats and providing them with a range of services), but had extremely poor access to information and were largely unable to persuade the firms toward more radical restructuring. In particular, the investment funds were only rarely able to effect managerial changes.

**2. <u>Enterprise performance and restructuring</u>.** On the basis of a large survey of enterprises conducted in July 1994, as the voucher phase of privatisation was coming to an end, Earle (1998) compared the effects of several types of new private owners -- insiders (managers and other employees) and outsiders (individual and institutional investors) -- with continued ownership by the state. Their work takes into account possible selection effects in the privatisation process that might bias the observed ownership-performance relationship. Controlling for other factors, Earle found that, overall, ownership change in Russia was already having some positive effects on labour productivity shortly after the conclusion of the voucher privatisation process, but that those effects were strongest in companies with concentrated outside owners (around 8.8% of privatised companies at the end of the voucher stage of privatisation). Concentrated outside owners did not have to be institutional investors. As noted above, the design of the Russian privatisation programme appears to have been biased against such institutional investors.

Nevertheless, the extent of the problems arising from insider control should not be exaggerated:

- There was clear evidence of higher average productivity and faster sales growth in privatised firms even where insiders retained control. Of course, this was partly a reflection of selection bias: investors may have spotted the more promising firms and ensured that they were privatised more quickly. This bias may have been particularly pronounced where managerial control obtained: insider managers might have known more about the enterprise's condition and potential than outsiders. However, studies controlling for the possibility of reverse causation and/or selection bias still found that private ownership had a strong impact on

enterprise performance, with ownership by managers and institutional investors having the strongest effects (Earle and Estrin, 1998; Broadman, 1998).

- There was considerable evidence by 1998 that, despite the under-developed nature of Russian capital markets and various impediments to the operation of a real market in corporate control, post-voucher changes in ownership structure were far from negligible. The shares held by private outside investors rose, but the main pattern observed was of an increase in managerial shares and a reduction in worker holdings. Since firms dominated by outsiders and managers both performed far better than predominantly worker-owned firms, this was good for enterprise performance. The big advantages for outsider-controlled firms came with respect to access to outside finance (Auktsionek et al., 1998).

- There was more restructuring under way in the mid-1990s than many realised at the time -- and, indeed, the response of the economy to the improved external environment since 1998 has in large measure reflected these changes. Between 1992 and 1996 around one-third of medium and large enterprises replaced their general directors -- 12% in 1995 alone. The presence of a strong outside owner greatly increased the probability of management change. Such enterprises also shed excess labour and raised productivity more rapidly (Blasi et al., 1996). The evidence suggests, moreover, that privatisation and competition were complementary: privatisation had a greater impact on firm performance in markets that were competitive and were dominated by privatised enterprises than it did where the privatised concern faced competition chiefly from state-owned enterprises. In short, competition among private firms appears to have yielded greater benefits than competition among those still in the state sector.

- As early as April 1995, a major national survey of workers in privatised and state enterprises (Earle and Rose, 1996) found major differences in patterns of enterprise adaptation. Workers in privatised enterprises were substantially more likely than their state-sector counterparts to report that their firms were changing product lines, investing in new equipment and paying their workers at least a part of their compensation in bonuses, piece rates or other forms linked to productivity. Workers in state-owned firms also continued to report high levels of ministerial influence over the enterprise's activities.

- Changes in the broader economic environment have been accompanied by important changes in insiders' behaviour. On the basis of a survey of 264 Russian enterprises, Krueger and Linz (2002) find that many 'defensive' enterprise strategies previously regarded as evidence of managerial resistance to restructuring are actually rational responses to acute illiquidity. They conclude (p. 34) that 'when managers have access to cash, they generally respond aggressively to whatever opportunities are present, whereas when liquidity constraints are binding, they restrict the scope of restructuring activities'. Here again, it is the environment rather than the fact of private ownership or the structure of that ownership that is critical.

The foregoing should not be taken to imply that Russian privatisation did not create serious problems. Many of the critics' points were undoubtedly valid. However, a growing range of work on Russia is beginning to confirm conclusions reached on the basis of comparative work across a number of transition economies (see, for example, Claessens and Djankov, 2002). Privatisation is associated with significant increases in sales revenues and labour productivity and, to a lesser extent, with fewer job losses. Critically, the positive effect of privatisation is stronger in economic magnitude and statistical significance as the time elapsed since privatisation increases. Enterprises privatised for less than two years differ little from state-owned enterprises in their performance. In contrast, enterprises privatised for three years or more significantly outperform state-owned enterprises.

**3. <u>Labour markets</u>.** The impact of privatisation on labour markets has been one of the less studied aspects of the transition. However, its impact is to some extent evident in data showing that real GDP

rose by around 20% in 1999-2001 (inclusive) against a backdrop of zero growth in total employment. Moreover, when employment began to grow in 2002, for the first time since 1994, job creation was concentrated overwhelmingly in the state sector. Private sector employment did not rise.

Brown and Earle (2002) study gross job and worker flows in Russian industry using panel data from a 530-firm survey. Their data cover such issues as the timing and definition of employment, the roles of break-ups and mergers, and the relative magnitudes of rehiring/new hiring and of voluntary departures and layoffs. They also provide coverage of firm characteristics that may affect job and worker turnover. Not surprisingly, Brown and Earle find that job destruction and worker separation rates in Russian industrial firms rose in the early 1990s, as did job flows as a fraction of worker flows and layoffs as a fraction of separations. By contrast, job creation and worker hiring rates were flat until 1999, the former remaining low and the latter surprisingly high.

Research suggests that private firms and privatised enterprises that have been reorganised display much larger flows compared with un-reorganised enterprises. Beyond that, however, they find that private ownership has ambiguous effects: insider ownership, particularly by managers, is associated with higher worker flows and excess job reallocation, while outsider ownership, particularly where outside ownership is concentrated, tends to be associated with lower flow rates. There is little evidence that firms' employment adjustments have become more sensitive to adjustment costs during the transition, but worker and manager ownership are associated with more sensitivity than are other types of ownership.

**4. Income distribution and poverty.** Commander et al.(1999) observe that, contrary to popular perception, Russia entered the transition with significant inequality, which increased sharply after the transition began. By end-1996, Russia was roughly comparable to Mexico, Colombia or Malaysia in terms of wealth inequality. Wealth transfers through privatisation do appear to have contributed significantly to this increase, but changes in government expenditure and a sharp growth in earnings dispersion were also important. Isolating the impact of privatisation with any precision is virtually impossible.

However, Alexeev (1999), examines how the Russian privatisation process was likely to have affected wealth inequality. Given that empirical evaluation is all but impossible due to the dearth of reliable and comparable data spanning the pre- and post-privatisation periods, he analyses instead the institutional features of Russian privatisation in terms of their effect on redistribution of wealth. He argues that the key is to evaluate the distributional consequences of privatisation in comparison to informal pre-reform property rights. This is a crucial issue, since many of the apparent winners from privatisation already enjoyed substantial de facto -- and, in some cases de jure (eg occupiers of flats who were able to privatise them for nominal sums) -- rights over the assets they acquired in the course of privatisation.

Alexeev concludes that the wealth-distribution effects of privatisation may best be conceived by modelling a rent-seeking contest in which those with informal rights over assets enjoy an incumbency advantage. His results suggest that privatisation served to magnify substantially this pre-reform wealth inequality reflected in the incumbency advantage. This approach also draws attention to the relatively large share of housing assets (both pre-reform informal rights and post-reform ownership rights) in the wealth of the poor.

**5. The fiscal impact.** There is little to add to the foregoing concerning the fiscal impact of privatisation. For the most part, Russian privatisation has served political rather than fiscal ends and has involved the large-scale transfer of assets to those enjoying informal rights over them prior to privatisation (ie. to insiders) at very low prices.

This view is confirmed by data on the proceeds from privatisation, which, with occasional exceptions such as the Svyazinvest sale of July 1997, have been very modest compared with the value of the

assets realised. In the peak year for privatisation revenues, 1997, income from the sale of state property totalled 4.044 billion dollars or 0.9% of GDP. In previous years, privatisation income had generally run in the neighbourhood of 0.1% of GDP or less (1995 being the sole exception). Total privatisation revenues for the period 1992-97 inclusive -- the six years during which the vast bulk of Russian privatisation took place -- amounted to just 6.84 billion dollars. In 2000 -- by no means a bad year in terms of privatisation revenues -- privatisation raised a total of just over 1 billion dollars for the federal budget, despite the economic recovery, efforts to improve the investment climate and the avowed determination of the new administration to do away with 'sweetheart' deals for insiders.

Similarly, privatisation revenues generally formed a tiny part of the revenue of the consolidated state budget until 1997 -- under 1% of total revenues in 1993, 1994 and 1996, and just over 1% in 1992 and 1995. The exceptional year was 1997, when a catastrophic shortfall in tax revenues was partly offset by a handful of major privatisation deals that raised the privatisation share of gross revenues to almost 3.3%.

In so far as privatisation has involved any fiscal benefits, these have been achieved via the separation of non-viable enterprises from the state budget. As noted above, one of the most important but least discussed aims of privatisation was to enable the state speedily to abandon such enterprises to their fate. However, it would be difficult, if not impossible, to quantify these expenditure-side benefits to the state budget, since privatisation did not achieve a complete separation of enterprises from the budget. Formal subsidies were, of course, slashed, but they were replaced first by soft credits and then by a bewildering array of informal subsidies which imposed substantial fiscal costs in terms of both heightened expenditures and revenue losses. These informal subsidies included the accumulation of massive (and unpenalised) tax arrears, the acceptance of non-monetary settlement of tax debts and the use of the country's energy and transport monopolies to subsidise ailing industrial enterprises (Tompson, 1999; Pinto et al., 2000).

Subsidy reduction was undoubtedly an aim of the Russian reformers. They were eager to cut enterprises off from the budget. At first glance, this appears to have had some impact. In 1992, federal subsidies of one sort or another (not just to enterprises slated for privatisation) amounted to 55% of GDP, with local authority subsidies equalling 14%. However, the relative importance of local subsidies increased as federal support was cut: local governments were keen to support (former) state enterprises. Thus, while federal subsidies fell to 17-20% of GDP in 1993, 7-8% in 1994, and just 1.5% in 1995, local subsidies actually increased from a low of 10% in 1993 to around 12% in 1994; local budgetary expenditure on subsidies remained more or less constant at just over 7% of GDP (other subsidies were financed off-budget). It should be noted that the fiscal data are so confused as to make it difficult, if not impossible to assess with precision the level of subsidy support being extended to state/privatising/privatised enterprises.

However, it is clear that cuts in budgetary subsidies do not tell the whole story. As fiscal subsidies were curtailed in 1992–93 the emission of soft credits by the Bank of Russia exploded, as did regional authorities' efforts to compensate local enterprises for reductions in central support via soft credits channelled through favoured local banks. Assessing the degree of subsidy here becomes even harder, because, as a subsidy mechanism, the issuing of soft credits was even less transparent than the use of the budget.

The next stage was even less transparent. As credit emission was curtailed, the authorities supported ailing enterprises by allowing them to run up tax arrears and arrears to the major infrastructure monopolies (mainly gas, electricity and rail transport) with impunity, or to settle tax, energy or transport debts in non-monetary form. EES and its regional subsidiaries, for example, not only could not bankrupt non-payers, they were usually not even permitted to cut them off. They therefore sought whatever payment they could -- bills of exchange, bartered goods, tax offset etc. The real value of bartered goods and money surrogates was far less (generally around 50-70% less) than their nominal value. This allowed the utilities to extract something from their debtors while at the same time

granting them large real discounts. The tax organs also did the same thing, especially at regional level, where the willingness to accept non-monetary settlement of tax debts was always greater than at federal level. (It should be noted that the entrenchment of these practices was facilitated by the opportunities they created for tax evasion and corruption).

Post 1992, Russian industry was not weaned off its dependence on subsidy but simply moved to progressively less transparent subsidy mechanisms. The role of subsidy provider shifted from the budget's expenditure side to the banking system and finally to the revenue side of the budget and the infrastructure monopolies. The instruments used were not soft credits or budgetary funds but payment arrears, barter arrangements and money surrogates. The effect, however, was the same: failing privatised industrial enterprises continued to represent a significant drain on the budget and on the rest of the economy.

For a number of years, this arrangement enabled the authorities, with substantial foreign assistance and the aid of some rather unorthodox financial practices, to achieve and maintain a semblance of macroeconomic stability without subjecting enterprises to hard budget constraints. This system broke down in 1998, when the resource-sector exporters and external lenders who had been financing it proved unwilling to carry on. It was the burden of subsidy that broke the budget: not the burden of explicit subsidies as an item of expenditure but the burden of implicit subsidies which meant that the authorities could not or would not collect sufficient revenue for the state to pay its bills.

## SECTOR-SPECIFIC ISSUES

### Resource Sectors

The state's holdings in the country's crucial resource-extraction sectors remain considerable. It still effectively controls a majority stake in the gas monopoly Gazprom (holding 38.4% of Gazprom directly plus 0.9% via the state-owned Rosgazifikatsiya; treasury shares, voted by management as the government directs, constitute another 16.1%) and maintains a tight grip on the diamond giant Alrosa, which accounts for about 20% of world diamond extraction. However, other major resource sectors (metals, oil, forestry) have been substantially privatised.

Where privatisation has proceeded in resource sectors, as in the oil industry, it has been plagued by all the problems described above. For many of Russia's oil majors, the most important phase of privatisation was the notorious loans-for-shares scheme described above, which involved Yukos, Surgutneftegaz, Lukoil, Sidanko and Sibneft. However, even where privatisation has taken place outside the loans-for-shares framework, Moser and Oppenheimer (2001) demonstrate that certain common patterns can be observed, many of which have already been discussed above:

1. Shares were generally acquired by insiders, whether via loan auctions or de facto management buy-outs by enterprise bosses using banks that managed the company's revenues.

2. Proxy companies were used as bidding vehicles to circumvent rules that would otherwise have prevented the collateral holders from acquiring their stakes.

3. Auction requirements have generally tended to exclude or at least handicap other bidders -- this was especially blatant in the loans-for-shares scams but it has also been evident in some subsequent sales.

4. Procedural obstacles have also been used to thwart outside bidders in cases where it proved impossible to exclude them from participating.

5. The amounts paid for shares acquired have consistently been below what most independent observers believe the stakes to be worth on the basis of such criteria as reserves, production or asset value.

Unfortunately, it would be very difficult to make the case that the pattern observed by Moser and Oppenheimer was unique to the oil sector. It represents a fair description of much privatisation in other resource sectors.

## Banking

In contrast to Central Europe, bank privatisation has not been much of an issue in Russia. This is partly because the extremely liberal licensing regime of the early 1990s favoured the rapid emergence of a large population of de novo private banks -- the origins of the de novo banks go back to the co-ops and Komsomol organisations of 1988 -- and partly because the most important state banks -- the retail savings monopolist Sberbank and the foreign-trade bank Vneshtorgbank -- remain firmly in the hands of the state. Over 40% of Sberbank is in fact owned by private shareholders (mostly insiders and other banks, but its shares are publicly traded, so many other investors now hold stakes) but the state retains a firm grip on it.

In contrast to Promstroibank, Agropromstroibank and Zhilsotsbank (the specialised state banks or spetsbanki created by the 1988 banking reform), Sberbank has essentially retained its institutional integrity. The spetsbanki fragmented to a considerable degree in the early 1990s as a result first of decentralisation and subsequently of the de facto 'secession' of many of their branches via new share issues, although Agroprombank and Promstroibank have remained among the largest Russian banks. There are at least three reasons why Sberbank did not break up in similar fashion (Tompson, 1998):

- Sberbank's local outlets never possessed the degree of autonomy enjoyed by the local branches of the spetsbanki, although conflicts between the all-Russian parent and provincial (republican) Sberbanks are by no means unknown.

- Sberbank's viability depends above all on its reputation as a bank that cannot fail, which in turn depends on its status as a state bank. If a regional Sberbank were to 'secede' from the parent bank, it would probably lose depositors rapidly.

- Because Sberbank performed a limited range of relatively simple operations for a very large number of clients, Sberbank managers were and are less likely than the managers of banks with a corporate focus to know their clients and to be able to build the kind of relationships needed to take those clients with them in the event of a separation from the parent bank.

This contrasts with the situation of managers in, for example, important regional branches of Promstroibank, who typically enjoyed established working relationships with a few key client enterprises.

Bank privatisation in Russia has, thus, been limited to the three spetsbanki. The privatisation of the spetsbanki began in 1990, prior to the Soviet collapse -- indeed, it was promoted by the Russian Federation authorities and was in part aimed at reducing the authority of the old Soviet Gosbank. The process proceeded fairly rapidly, in a decentralised fashion and with remarkably little publicity. Control rights passed from the state to managers, as the TsBR (the all-union Gosbank's Russian rival) encouraged the regional branches of the banks to declare independence. The TsBR first ordered that the assets and liabilities of all three spetsbank be transferred to its own regional branches. The TsBR then offered the managers of the spetsbanki branches the choice to form their own small banks or to join together in larger banks. This question was generally resolved by regional branches' managers in consultation with regional authorities and with their major clients, a process that helped ensure the

process went smoothly. The banks' central headquarters had little leverage, because the assets and liabilities were being held by the Central Bank and were returned to the banks on a branch-by-branch basis only after the issue of ownership had been resolved. The result was that a number of small spin-off banks emerged from the three giants, although three substantial banks did emerge from the process by uniting large numbers of branches: Promstroibank, Agroprombank and Mosbiznesbank (on the basis of Zhilsotsbank).

This process was driven by a combination of insider interests and high politics -- specifically, the conflict between the Russian Republic and the all-union Soviet leadership. The government received virtually nothing from the process; it was, to a great extent, a genuine give-away privatisation.

Nevertheless, Abarbanell and Meyendorff (1996) conclude that it had a number of (largely unintended) beneficial effects. Because the process was undertaken at an early stage and executed rapidly, the banks were still solvent when it happened. The authorities never had to undertake extensive recapitalisation programmes or to relieve the banks of their inherited bad debts (which were in any case eaten up by inflation in the early 1990s). This contrasts with the experience of Central European countries, where bank privatisation has often proved a lengthy and very expensive process. Where governments have delayed bank privatisation with a view to increasing franchise value and thus raising potential privatisation revenues, the opposite has generally been the result. At the same time, the rapid withdrawal of the state from the corporate governance of the banks freed them to compete with the rapidly growing new private banks. The result was that the banking sector became one of the most innovative and rapidly changing in Russia.

It did not, however, become a banking sector, in the sense that neither the privatised banks nor their private counterparts engaged in much actual financial intermediation, which is generally reckoned to be the core activity of a bank. The combination of rapid bank privatisation and a liberal regime for the creation of new private banks facilitated the rapid emergence of a large number of financial institutions providing a wide range of services, some of them quite sophisticated. These institutions were and are profit-seeking and sometimes highly innovative, but they do not for the most part act as banks – i.e. as commercially driven financial intermediaries. Here again, it is critical to look at the environment in which privatised entities operate. Given the economic environment in which they work, the regulatory framework and the power of the state in Russia's economic life, the banks' behaviour has been generally rational. Continuities in bank behaviour arise mainly from environmental constraints rather than bankers' preferences (Tompson, 1997, 2000).

## Public Utilities

Little formal utility privatisation has taken place and where it has (eg in electricity, which is part-privatised) the process of restructuring the sector is in its infancy with discussions of ideas such as Public-Private-Partnership's some way off.

Housing and municipal utilities have benefited from little reform and are in desperate need of restructuring. The services provided are poor and unreliable, and the system for financing them is both inefficient and socially regressive. It is inefficient because subsidies are paid direct to public-sector HMS (housing and municipal subsidies) providers rather than to households, ensuring that the sector remains un-competitive. Many HMS providers are effectively bankrupt -- their overdue payables, mainly to EES Rossii, totalled 200 billion roubles in early 2002. It is regressive because subsidies are directly related to household living space, which means that better-off households tend to receive greater subsidies. In principle, the Russian authorities are committed to restructuring the country's utilities and major infrastructure monopolies (gas, electricity and rail) by separating their 'natural monopoly' elements (the national grid in the case of electricity, the pipeline network in the case of gas) from their potentially competitive elements (gas production, electricity generation etc.).

In practice, this has proved extremely difficult, because many of the entities involved were part-privatised before the restructuring process began. Moreover, these are generally complex structures, comprising parent companies and numerous subsidiaries (and subsidiaries of subsidiaries), whose ownership structures are not identical.

In the case of EES Rossii, the country's electricity monopoly, this has massively complicated the restructuring process. Centre-regional conflicts -- between governments and between the parent EES and its regional subsidiaries (the so-called energos) -- are compounded by conflicts between the interests of EES management and private investors, as EES's minority shareholders fight any restructuring that would destroy shareholder value. Reformers must also address the concerns of the Duma (particularly the left opposition) and the other ministries active in the sector, such as the Ministry of Atomic Power, which operates its power plants outside the EES system and is locked in a state of more or less permanent conflict with the company. Concessions made to satisfy one group of stakeholders often arouse the opposition of others.

Gazprom's situation is rather simpler, but here, too, the government has found it difficult to press ahead with restructuring in the face of opposition from insiders. The replacement of Gazprom's top management and the reassertion of the federal government's ownership rights have brought some improvement in the management of the company and the recovery of assets alienated by the old management team. However, even the new CEO, Aleksei Miller, has rejected giving up Gazprom's pipeline network, let alone breaking the company up. Gazprom need not be split up in order to generate competition in gas production -- there is plenty of scope for non-Gazprom production on the part of Russian oil companies and new fields are being developed with the participation of foreign investors. However, liberalising access to export pipelines will be critical to creating a level playing field.

In short, the government is in a trap of its own making. Having created property rights in these sectors, it finds it difficult to press ahead with needed restructuring without compromising those rights. However, here too it would be a mistake to attribute too much of the problem to privatisation: insider resistance to restructuring has been similarly effective in sectors that have not undergone privatisation at all, such as the railways sector and atomic energy, both of which are still run by federal ministries.

In early 2001, Putin set a target for phasing out housing and utilities subsidies for all but the poorest citizens (for whom targeted assistance was to be provided) and completing the shift to a system of full payment for most citizens no later than 2003. This would have hit household budgets in the run-up to the parliamentary-presidential election cycle of 2003–04. Less than a year later, however, the government decided to delay the shift from universal to targeted subsidies to 2004 and beyond. Whenever the subsidy cuts take effect, it will inevitably be the case that households will begin to pay more long before services show any real improvement. In the meantime, local authorities continue to increase utilities charges because they have no other way to finance this sector. However, these hikes are adopted locally and do not form part of any broader reform plan, let alone privatisation of the sector.

## Remaining State Property

To appreciate fully the impact of privatisation, it is necessary to consider the Russian state's performance as a property owner. Critics of Russia's chaotic and often corrupt privatisation processes often argue that the speed of privatisation was a mistake and that it would have been better to slow the process down, allowing the state to restructure its assets ahead of privatisation, while simultaneously moving ahead with the legal and institutional reforms needed to make privatisation effective. In fact, the Russian state's record as a property owner strongly suggests that this approach would have yielded

poor results. The state has allowed its assets to be stolen, devalued and mismanaged, while managers and officials pocket a large share of the proceeds from their exploitation.

According to the Ministry of Property Relations, at end-2000 there were around 37,000 enterprises and institutions in federal government hands, including over 13,700 state-owned unitary enterprises. In addition, the federal government, in one guise or another, held stakes in 3,800 joint-stock companies; of these, the state share exceeded 25% in over 2,500, while some 382 were 100% state-owned. Some 697 of the 2,500 produced output regarded by the state as being of strategic significance; the remaining state shares in these companies were, therefore, not subject to early privatisation. The state also held 'golden shares' giving it special rights (out of proportion to its shareholdings) in some 580 companies. Yet the state's total income from the management of all this property (including privatisation) amounted to just over 50 billion roubles in 2000, a clear sign of ineffective management.

Even this low level of income, however, represents an improvement. The state's income from state property was, until 1998, virtually negligible. The state's total income from leasing state property and dividends on state shares in 1997 was just 575.7 million roubles (around 98 million dollars at the time). In 1998, only 273 of the corporates in which the federal government held shares paid dividends on the basis of their 1997 results. Some 700 showed signs of insolvency and were in no position to pay dividends, while 238 were profitable but declared that net profits were too low to pay dividends. The remainder (over 2,000) showed no profit. Of those companies that did pay dividends, five (Gazprom, EES Rossii, Lukoil, Almazy Rossii Sakha and Transneft) accounted for 86% of the government's dividend income. Another 24 accounted for 10.3% and the remaining 244 for 3.7%. These meagre results do not simply reflect the actual performance of companies in which the federal government holds shares: rather, profits are hidden and shareholders (including the state) are not receiving the income that is due them.

Though official, the above figures are, it should be noted, only approximate. The administrative, political and legal confusion of the 1990s, coupled with outright corruption in many cases, meant that many state assets were never legally privatised at all -- they were simply 'lost'. This included whole enterprises which continued to function but were simply lost sight of by the state entities that owned them. The vagueness of the data on state property further testifies to how poorly it is managed. Thus, the capitalisation of companies in which the state held stakes in 2000 was reckoned on the very lowest estimates to be at least 50-60 billion roubles (1.8-2.1 billion dollars at the then-prevailing exchange rate) but yielded dividends worth only about 1% of that amount. The ministry, moreover, believed the value of state stakes was actually much larger, although estimates of the dividend income are correct; the yield was thus nearer 0.2%. The management of state-owned real estate has not been much better. Although the state is by far the largest landowner in Russia, income from the leasing of state-owned real estate in 2000 was under 6 billion roubles.

**Post-privatisation.** The information on post-privatisation review mechanisms regarding investment and performance commitments is limited:

1. Relatively few privatisation deals (as a proportion of the total) involved investment or other performance commitments.

2. Many that did specify such commitments failed to provide explicitly for redress on the part of the state in the event of non-fulfilment of these conditions.

3. Some state institutions, such as the State Duma and the Accounts Chamber of the Federal Assembly, have investigated past privatisations, uncovering evidence not only of violation of investment and performance commitments but also of other violations of the law in the course of privatisation. However, these investigations have had little impact for the following reasons:

- A number of the investigations appear to have been clearly politically motivated (or, in some instances, performed 'to order' by disgruntled losers seeking to challenge new owners' control). This makes it easy for new owners to 'counter-lobby' the government to protect their interests.

- Even with no clear evidence of political motivation, new owners have generally been able to protect their newly won positions.

- There is a general fear of any wide-ranging review of privatisation. This reflects in part a positive concern with establishing clear, secure, tradable property rights as fast as possible, however imperfectly these were allocated to begin with. As long as property rights remain unclear and insecure, agents will face incentives to focus on control contests and those controlling assets will have more of an interest in stripping them than in investing in their development. A second fear is that any serious attempt to undo the property settlement of the 1990s could bring about political and economic instability.

4. Finally, private agents have sought to mount challenges to new owners by bringing suits based on alleged privatisation violations. Owing to the procedural defects of Russian legislation (many of which have recently been amended) and the weakness of the rule of law generally, such conflicts have often been legally confused (with courts of general jurisdiction and arbitration courts sometimes awarding opposing judgements in the same dispute), corrupt and highly politicised.

**Alternatives to privatisation.** The Russian Federation still has no law on concessions, which is one of the reasons it has made no progress in developing PPPs or similar vehicles for developing infrastructure projects. Russia has adopted the bulk of the legislation needed to create the legal framework for a market economy; the absence of a law on concessions is one of the biggest remaining lacunae.

**Role of Multilateral Institutions.** The multilateral institutions have often come in for criticism from those attacking Russian privatisation -- the Russian government's western advisors in general and the Bretton Woods institutions in particular are often regarded as having been at least partly responsible for encouraging very rapid privatisation, which in turn led to a good deal of chaos and corruption. This criticism is largely misplaced. Many westerners close to the Russian privatisation process had considerable misgivings about what was done. Some did indeed regard even a flawed scheme for rapid privatisation as preferable to delay, while others were more cautious. However, the West's views were decidedly peripheral. Russian privatisation was driven from start to finish by Russian politics. The major lines of economic policy after 1992 were determined by Russian governments acting (or failing to act) principally in response to domestic opportunities, incentives and constraints. Privatisation was no exception.

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# PRIVATISATION IN SPAIN

## LEGISLATION AND METHODS

Spain has implemented one of the largest privatisation programmes in Western Europe. During this process the state-owned enterprise sector (SOE) has been reduced from a large number of diverse companies in the early 1980s to a rump of businesses in 2002 (Gamir, 2001; Salmon, 2001). The majority of the remaining SOEs, which do not have exceptionally large deficits, are due to be sold by 2004 -- the next parliamentary election. The current government does not plan to privatise those services delivering direct public services such as the letter post, railways, health, education and social services. Coalmining, shipbuilding, air and seaport operation, and some radio and television channels also remain in state hands.

### Privatisation Objectives

Bel and Costas (2000) identify three phases in the privatisation process: the 1980s under the Socialist Party, Partido Socialista (PSOE), the first half of the 1990s (also under the PSOE), and the period from 1996 to the present under the PP:

1. **Pragmatic privatisation.** Privatisation began under the PSOE in the early 1980s as a pragmatic response to industrial problems (Aranzadi, 1989). The objective of privatisation was essentially to save failing businesses (Aranzadi, 1989; Fanjul and Manas 1994; Gamir, 2001). The process formed part of a broader industrial policy of returning the industrial sector to viability (reconversion industrial) following severe economic problems in the late 1970s and early 1980s. Flotations diversified sources of finance, broadened the base of shareholdings and introduced the discipline of the market into management. Sales to other companies (apart from the banks in the early 1980s and the special case of the Rumasa group) provided the opportunity of gaining access to private capital, technological, logistical or commercial expertise and facilities (for example, developed networks of international distribution), economies of scale and industrial synergy. These opportunities were considered to offer companies a more secure future. In general, privatised businesses (mostly manufacturing companies) were kept going by their new owners and in many cases substantially modernised. The most important example was that of the car manufacturer Seat, which continued as a major manufacturing plant within the German Volkswagen group.

2. **Revenue raising.** In the early 1990s, the principal objective of privatisation switched towards raising money for the state (Gamir, 2000, Pampillon, 2002). Stakes were sold in the state-owned bank Argentaria, the electricity utility Endesa, the national oil company Repsol and the national telecommunications company Telefonica. There were no full privatisations of major enterprises, suggesting that greater business efficiency was only a secondary objective (Pampillon, 2002). Increasing pressure for the sale of public companies came from the need to control public expenditure and reduce the public sector deficit in an effort to retain international confidence in the economy and meet the convergence criteria set out in the Maastricht Treaty. By 1993, the general government deficit in Spain had grown to 6.8% of GDP (OECD, 1998a). The OECD estimated that public enterprises may account for one-quarter of the general government debt. Although the European Commission prohibited the proceeds from privatisation being used directly in the calculation of public sector deficits, they could be used to reduce or reschedule public debt and sustain loss-making companies. The sale of state enterprises also removed the risk of future liabilities. Although privatisation was not the only factor involved, by the turn of the century the public sector deficit had been eliminated.

3. **Asset disposal.** Following the election of the PP in 1996, the privatisation programme was accelerated, the objective being to dispose of all state-owned enterprises. There were no longer

strategic sectors nor special cases where the public sector should remain in control (Prada Gayoso, 1997). The principal stated objective shifted to increasing efficiency, both of the companies privatised and of the economy (CCP 2002; Gamir, 1999; Pampillon, 2002). A growing body of evidence pointed to increased efficiency associated with privatisation (Argomon et al, 1997; Cuervo, 1999; Garcia Echevarria, 1999; Sanchis, 1996). However, reducing the public sector deficit clearly remained a priority, as illustrated by the timing and value of sales (Verges, 2001). The PP also supported the objective of popular capitalism. From 1996 to August 2002 the privatisations were completed (except for a 'golden share' and residual shareholdings in some cases) of Argentaria, the national integrated iron and steel company CSI (Aceralia), Endesa, the national airline Iberia, Repsol, the tobacco company Tabacalera, Telefonica, and the national shipping company Transmediterranea. In total, between 1996 and the end of 2001 there were 51 privatisation operations involving 43 public enterprises (CCP, 2002). All of the major companies privatised since 1996 have become internationally competitive businesses. Endesa is one of the largest electricity utilities in Europe with significant investments in Latin America. Repsol-YPF is one of the world's top ten oil companies with interests in natural gas and electricity. Tabacalera joined with the French group Seita to become a leading international tobacco company (Altadis). Telefonica is the dominant telecoms company in Spain and Latin America and has important media interests. All of these are now judged by independent analysts to be efficient, internationally competitive businesses.

The privatisation programme adopted in 1996 has been an integral part of the liberalisation and structural reform process that has been a major plank of Spanish economic policy in recent years. From being coerced into liberalisation by external pressures in the past, Spain has become an advocate of the process. A major theme of the Spanish EU Presidency in the first half of 2002 was liberalisation, especially in financial and capital markets and in network services (energy, postal services, railways, telecommunications and water).

## Privatisation Process

During the 1980s, privatisations were of relatively small, mostly manufacturing, companies, with the notable exceptions of a 25% holding in Endesa, a 30% holding in Repsol and the full privatisation of the former state-owned motor-vehicle company Seat in 1990. Again, with the exception of the utility and energy companies, privatisations were trade sales to other companies, many of which were European multinationals. The early 1990s were dominated in value terms by sales through flotations on the stock market of partial holdings in energy companies and in Telefonica. Partial sales secured the objective of raising finance for the state, while allowing the state to retain control.

In 1996, the right-of-centre Partido Popular (PP) launched an explicit privatisation programme -- the Public Sector Modernisation Programme (Programa de Modernizacion del Sector Publico) -- that:

- was embedded in a broader economic policy of liberalisation;
- was global in coverage;
- embraced full privatisation of the majority of major public enterprises (except for the retention of a 'golden share' in major companies -- enabling the government to retain a veto over strategic decisions by the companies for a specified period of time;
- handed the main decisions over privatisation to managing agents (SEP, SEPPa, AIE) rather than the companies; and
- embraced the principles of competition, transparency and independent valuations.

This was in line with IMF and OECD recommendations on the types of structural measures necessary, in their view, to create sustainable long-term growth. The 1996 Programme divided companies in the public enterprise sector into four groups according to profitability and ease of privatisation:

1. Profitable companies with consolidated markets: Argentaria, Repsol, Tabacalera, Telefonica and Transmediterranea. All companies in this group have been sold.

2. Companies operating in markets which were still to be liberalised, and where the sector required reorganisation. This group included Endesa. Most of these have been sold.

3. Companies which still required consolidation and restructuring to guarantee their future: These included the mining company Almagrera, the construction group Auxini, the engineering company Babcock Wilcox, the aeronautical company Casa, the shipping company Elcano, the paper manufacturer Ence, the mining company Grupo Potasas, Iberia, the electronics company Indra, the aluminium manufacturer Inespal and the insurance company Musini. Most of these have been sold.

4. Companies that depended on the state budget and had been undergoing substantial reorganisation (major loss-making companies): these included those in the then State Industrial Agency (AIE), like the coal-mining group Hunosa. Although some of these remain in the state sector, others such as CSI (Aceralia) and the shipbuilder Barreras have been sold following reorganisation of their activities and the injection of public funds.

## Privatisation Framework

From 1997, a new legal framework for privatisation was introduced (Pampillon, 1997). Two bodies acted as 'managing agents' for the privatisation process: SEPI (Sociedad Estatal de Participaciones Industriales) and SEPPa (Sociedad de Pivatizacion del Patrimonio). In 2001 these two bodies were united to become SEPI, based in the Ministry of Finance (Ministerio de Hacienda). The State Audit Office (Intervencion General del Estado) was responsible for financial control of the process. Democratic accountability was through a parliamentary committee (Comision de Industria del Congreso). In addition, the Privatisation Consultative Council (Consejo Consultivo de Privatizaciones) was set up (comprising seven academics and a president nominated by the government), charged with ensuring the transparency and openness of the process (Pampillon, 1997). The managing agents for the sale of each company forwarded their proposals to the Council, which then commented on them with regard to the transparency of the process. From Autumn 1998 the Council produced reports, based on its remit, on companies already privatised.

**Main methods.** A wide variety of methods have been used during privatisation operations in Spain (CCP, 2002; Gomez-Acebo and Pombo, 1997; Montes Gan and Petitbo, 1989). Most were trade sales, but the largest proportion of income has been raised through flotations. Between 1996 and the end of 2001, 68% of the income generated by privatisations arising through public share offers (and 56% of all income from privatisations) corresponded to retail investors and 32% to institutional investors (CCP 2002). Hence share ownership was extended. The success of these operations depended on the state of the stockmarket. At the height of the boom in 1999, the public offer for sale of Indra was 39.2 times over-subscribed. In contrast, the allocation in Iberia in 2001 was only 1.2 times over-subscribed (ibid):

**1. Trade sales.** During the 1990s trade sales generally involved more profitable companies. A bidding process evaluated the business plans of companies against published criteria. However, although statements are released as to why individual companies are successful in this process, the full reasoning behind decisions remains confidential. Frequently these sales have been to Spanish groups, strengthening their position in the market-place:

- Direct adjudication (negotiated direct sale). Adopted when companies have been technologically or commercially non-viable. Examples include the textile firm Intelhorce and the motor-vehicle company Enasa. This procedure was common in the 1980s and, for the most part, involved small manufacturing companies. More recently the procedure was used for the sale of the metal fabricating company Conversion Aluminio (CA) in 2001. Usually the 'Advisor' has to make a large number of contacts before an offer is made. In the case of CA, 147 potentially interested parties were contacted; in the case of ENSB, the figure was 53. In these recent examples the acquiring company has been required to make certain pledges on investment and employment in their business plan for the target company. The method is open to corruption. For example, Intelhorce absorbed substantial public funds passing back and forth between the private and public sectors until eventually it collapsed.

- Open public auction. Adopted when the securities to be sold have not been listed on the stock market. In 2001, this procedure was used to sell seven farms that belonged to the SOE Expasa.

- Competitive tender. Utilised where the business being sold is basically sound and the character of the business plan -- including the level of anticipated investment and commitments to the workforce -- are more important than the price offered. The first phase of the sale of the telecoms group Retevision is an example.

- Restricted access competitive tender. Only a restricted number of companies are considered as potential buyers, as, for example, in the sale of the defence group Santa Barbara and Babcock Wilcox. This method overlaps with direct adjudication.

- Mergers. In the case of the aeronautics company Casa, the privatisation became part of the reorganisation of the European aeronautics and defence industry and the formation of the company EADS.

**2. Stockmarket flotation.** Flotation is supported by the CCP because it lends itself to the principles of competition, transparency and market valuation, and is supervised by the stock market regulator (CMV). Examples include: Aceralia (CSI), the distribution company Aldeasa, Argentaria, Endesa, the natural gas supplier Gas Natural, Indra, the electricity grid operator Red Electrica, Repsol, Tabacalera and Telefonica. There are different types of flotation:

- Partial flotation. Offering shares through a number of tranches has been the principal procedure for floating large companies. Its major advantage is in providing a measure of the market value of a company, reducing valuation risk in an initial public offering (IPO).

- Full flotation. This is a public share offer for the entire company. There have been no examples of companies privatised wholly through a single public share offer.

- Split capital privatisation. Many privatisations in the 1990s involved splitting the capital of companies.

- Stable shareholder group. An allocation of capital (normally 20% to 30%) is made through competitive tender to a small group of companies (normally three to five), designed to create a core of stable shareholders. This procedure was used from the mid-1990s: for CSI in 1997, Indra in 1999, Iberia in 2000 and Ence in 2001. In the case of Ence, a core shareholding group was formed by three banks following contacts by the Assessor with 45 businesses (CCP, 2002). This procedure safeguards national ownership of the enterprise.

- Industrial partner. An allocation of capital (normally around 10%) is made through direct adjudication or competitive tender to an industrial partner. This procedure was used, for

example, in the privatisation of Indra and Iberia (where the partners were British Airways and American Airlines). It allows the enterprise to secure the resources of a business partner (generally a foreign multinational), without losing control to the partner.

- <u>'Golden share' (as approved by legislation in 1995)</u>. In all of the major privatisations since the mid-1990s, the government has retained a 'golden share', providing a veto for a specified period of time over certain decisions by the company. The golden share provides the government with a veto in cases involving strategic decisions, notably where a merger is proposed; where there is a change in social objectives; sales of shares; or the acquisition by another body of 10% or more of the capital.

- <u>Retail and institutional allocations</u>. Capital floated on the stock market can be split between an allocation to small investors (retail tranche) and an allocation for institutional investors (often split between national and foreign institutions). Reserving an allocation to small shareholders promotes the objective of popular capitalism. Before 1996, 48% of public share offers were to retail investors, rising to 68% after 1996 (CCP 2002). The allocation of capital to a stable shareholder group and to industrial partners precedes the flotation of the remaining capital on the stockmarket. For example, in the case of Iberia, industrial partners (British Airways and American Airlines) were initially found for a small stake (10%) in the company. Then Spanish institutional investors, three banks and two non-financial companies, were invited to bid for a proportion (around 30%) of the capital. Once this stage was completed, the bulk of the remaining capital (53.7%) was floated on the stock market (67% to retail investors and 33% to institutions, of which 17% were national and 16% foreign.

- <u>Block trade</u>. Sometimes used where the government has had a small block of shares to sell, for example where Seppa had a small holding in Telefonica.

- <u>Other models</u>. There have been very few examples of worker and management participation models. Two examples of management buy-outs were Iongraf in 1996 and Ferroperfil in 1997, both spun off from the SOE aluminium company Inespal.

**<u>Privatisation methods by category of enterprise</u>.** The government has favoured different methods of privatisation according to the type of company to be sold:

- Public utilities with monopolies: ownership broadened through a mix of institutional sales and flotation (e.g. the gas grid operator Enagas).

- Public utilities where at least some competition is possible (e.g. telecommunications): generally sold through phased flotation.

- Resource-based large-scale enterprises (e.g. mines): generally sold through trade sales.

- Large enterprises in sectors with natural barriers to entry: generally sold by flotation.

- Banks and financial sector institutions, including those serving poorer people: Argentaria sold through flotation.

- Other large enterprises: generally sold through flotation.

- Land: sold by public auction.

**<u>Small and Medium Enterprises (SMEs).</u>** Many of the companies privatised have been in this category. They have been sold through some form of trade sale. For example, the electronics company Secoinsa was sold to Fujitsu in 1985 (it is still operating). Occasionally they have been sold through a

management buyout (e.g. Ferroperfil in 1997). Because they are small and because they have generally been absorbed into larger companies, there is little information on their subsequent experience, except where there have been major scandals (as in the case of Intelhorce).

## Alternatives to privatisation

Spain has adopted a number of forms of business organisation short of privatisation. These include the legal constitution of a 'public trading company', the use of contract programmes in which companies are allocated public funds on the basis of agreed targets (e.g. in Renfe), the division of companies into business divisions (e.g. Renfe) and in the case of the postal service Correos, the break up of part of the business (sale of the banking division).

It is difficult to make an assessment of the alternative models to privatisation, since they have neither been that widely used nor for that long. Both the national rail company, Renfe, and the post-office 'Correos' have reduced losses in recent years and become more efficient. If mutuality is considered an alternative, then some of the savings banks, notably La Caixa and Caja de Madrid have been very successful as measured by their profitability, growth, and ratings attached to their debt.

**Mutuality.** Savings banks provide the best examples of mutuality in Spain. They now operate on a similar footing to commercial banks. However, they have a different legal constitution and are oriented more to families and small business customers. The number of savings bank branches has continued to grow in the last decade as they have expanded out of their original 'home' areas. They account for about half the deposits and loans in Spain. The two largest are La Caixa (based in Barcelona) and Caja de Madrid (based in Madrid).

There are two types of savings bank - general savings banks and rural savings banks. Many general savings banks were initially founded by the Church in the eighteenth century as non-profit-making institutions, and a small number are still owned by the Church. Roughly one-third were founded by local governments (especially provincial governments). The rural savings banks ('cajas rurales') were co-operative ventures set up at the beginning of the twentieth century. They specialise in finance for agriculture, fishing and related industries (including lines of official credit and short-term loans) and technical assistance to agriculture. In 2002 there were 78 entities in the rural savings bank group.

Savings banks are run as foundations through general councils ('consejos generales') consisting of a prescribed mix of savers, employees and representatives of local authorities (there are no shareholders). These are nominated by the 'asambleas', equivalent to the shareholder meetings of private companies. They have 60-160 members and they propose the members of the 'consejo de administración' (Board). The governing councils also elect a president.

The composition of the governing councils, on which political parties have seats, has meant that local political considerations have influenced management policy, including policy on expansion and mergers. In the past there have been failures of savings banks, but in the last five years they have generally been very profitable and certainly some are very efficient and competitive businesses. Profits must be ploughed back into operations or else put into public works benefiting the community (savings banks are very big benefactors of their local communities).

Liberalisation in the sector has paved the way for mergers among the savings banks and for acquisitions of commercial banks (commercial banks cannot acquire savings banks). Many mergers have occurred but greater consolidation has been hindered by intense personality conflicts and local rivalries. There has been relatively little international expansion by savings banks.

The Bank of Spain and the government have been concerned that political influence is too strong in the savings banks, diverting policy from economic rationale. There has also been concern that the

savings banks are too insulated from competition. The IMF and others have recommended privatisation. The government have said that there will be no pressure to privatise in the current legislature (to 2004). Nevertheless, the government has introduced new legislation in 2002 on the operation of savings banks. They are now allowed to raise capital through the issue of 'participation quotas', stock that is not accompanied by equivalent voting rights (preventing savings banks being acquired). There is widespread opposition to the possibility that savings banks could be acquired by other businesses.

### Public-Private Partnerships

These have become more popular since the 1990s. They have been used mainly in large transport infrastructure works, notably motorways and railways. Current transport infrastructure development plans assume a significant element of private financing.

For the purposes of solving the problem of financing the building of railway infrastructure the Partido Popular created the GIF (Gestor de Infraestructura Ferroviarias), a public trading company based in the Ministry for Development. The legal framework was approved by Real Decreto 613/1997 (25 April). Its purpose is to construct and finances new lines (currently the high speed line to Barcelona) and then to manage these lines. Its funds come from the state, the EU, tolls paid by operators, state loans or bank loans.

## THE IMPACT OF PRIVATISATION

The impact of privatisation can be explored at a number of levels:

**1. <u>Labour markets</u>.** Privatisation affected five interrelated areas: labour costs, employment in former state-owned enterprises, unemployment levels, flexibility and trade union power (Salmon, 2001). High unemployment, a large underground economy and inflexibility all characterised the Spanish labour market in the last two decades of the twentieth century. These characteristics were partly attributed to a large public enterprise sector. Privatisation provided an opportunity for the government to reduce its exposure to direct labour market negotiations, freeing itself to introduce measures to increase flexibility in the labour market. It was argued that such flexibility would improve the rate at which the Spanish economy created jobs during periods of growth. According to the OECD, it is clear that strict employment protection legislation and other labour market policies were a central element of Spain's poor labour market performance up to the mid-1990s (OECD, 2000).

Public enterprises were generally overstaffed and thus exposed to substantial cuts in employment. Many experienced sizeable cuts during 'reconversion' programmes in the 1980s and further cuts as they were prepared for privatisation (Prada Gayoso, 1997). Once privatised, companies rationalised their labour force to increase productivity. Between 1981 and 1994 the labour force in public enterprises contracted by 58%, in mining by 49% and in defence by 41% (Gamir, 1999). However, in the medium term, the major privatised companies were able to grow their businesses and diversify into other markets, leading to employment creation (Hernandez, 2000). For example, the average number of employees in the Telefonica group increased from 74,437 in 1992, to 92,151 in 1997 (the year in which privatisation was completed) to 161,029 in 2001. However, in the core company Telefonica de Espana there were 11,000 job losses in 1999 and 6,000 in 2000 (Telefonica, 2002). For companies sold directly to other companies, part of the adjudication process was to have a commitment to employment in the business plan. Finally, liberalisation of markets introduced new companies (e.g. in telecommunications), creating new jobs (Hernandez 2000).

Public enterprises were held to contribute towards higher labour costs and were the sites of strong trade union power. According to the OECD wages appeared to be too high in the public enterprise sector (OECD 1998a). The OECD concluded that, until the early 1990s, wage increases in public enterprises consistently exceeded those for the private sector by a large margin. In sectors with both private and public enterprise participation, sectoral collective agreements distorted wage bargaining in the private sector. These higher labour costs could be explained partly by the more rigid labour market conditions that prevailed in the public enterprise sector. According to the OECD, public enterprises had less flexible employment contracts, resulting in a much lower job turnover rate and higher dismissal costs. Public enterprises' internal labour organisation was also characterised by lower functional and geographical mobility of the workforce. The OECD concluded that higher wages, shorter hours worked, more secure employment, better training opportunities and other fringe benefits provided an incentive to seek employment in a public enterprise. It was argued that privatisation contributed to a weakening of trade union power through reducing direct political involvement in labour negotiations (Bos, 1998).

**2. Income distribution/poverty.** There is little direct reference to the impact of privatisation on income distribution -- either among individuals, social groups, or regions -- or on poverty. In general, privatisation involved a transfer of assets from the state (all the people) to a relatively small number of private shareholders, often large institutions (pension funds, banks etc.), which, in turn, were often outside Spain (foreign multinationals and other institutions). Dividends from privatised companies were thus distributed to those on higher incomes within Spain or transferred abroad.

Overall, privatisation, as part of a broader shift in the economy towards liberal capitalism, has probably contributed to a widening of the gap in income distribution within Spain:

- The provision by public enterprises of products and services below market prices (largely justified on the grounds of social benefits and externalities) are generally of greater benefit to low income groups. (Rail transport, post and social services have not been privatised in Spain.)

- Loss-making public enterprises may be kept going to support employment, involving a redistribution of income to these workers. Some geographical areas have been severely damaged by public enterprise restructuring. This has been compensated for by generous termination payments and pension schemes. There appears to be some acceptance of the social benefits argument (as expressed through the retention of the state railway company, Renfe). On income redistribution, methods other than public enterprises are held to be more efficient (Gamir, 1999).

- Sounder public finances have enabled income taxes to be reduced, benefiting higher earners more than those on lower earnings.

Nonetheless, economic growth above the EU average has resulted in per capita incomes in Spain gradually converging with the EU average. According to the European Commission, GDP per capita at purchasing power parity in Spain in 2001 was 84.3% of the eurozone average, compared with 78% in 1995.

**3. Investment and growth.** While the precise relationship with growth patterns is difficult to demonstrate, privatisation has been accompanied by a good growth record in comparison with other EU countries. Growth accelerated to over 5% per year in the late 1980s, slowing at the turn of the decade. Following a short recession in 1992-93, growth began to build again in the mid-1990s, reaching 3-4% at the turn of the decade. Although growth declined to 2% in 2002, it remained above the EU average. This good growth record over the last twenty years has occurred in conjunction with privatisation and liberalisation.

Privatised companies include most of the leading companies in Spain and account for a large slice of total national investment. All the large privatised businesses have substantially increased their investment (Henandez, 2000) in order to remain competitive. Telefonica has by far the largest investment budget of any company in Spain. In 1999, 2000 and 2001 investment was valued at 7.2 billion, 21.1 billion and 8.4 billion euros respectively (Telefonica, 2002). This contrasted with 3.6 billion euros in 1995. In the five-year period 2002-06 Endesa planned to invest 13 billion euros, 90% on its electricity business (Endesa, 2002). By way of comparison, the total allocation for direct investment in the Consolidated Budget for Spain in 2003 was only some 10 billion euros (Ministerio de Hacienda, 2002). All of the leading companies now devote more resources to investment and technological development than when they operated as public enterprises.

**4. <u>Impact on government fiscal and quasi-fiscal positions</u>**. Under successive PSOE governments from 1982 to 1996, gross receipts from privatisation were estimated at around 13 billion euros (1996 prices) (Gamir, 1998; Pampillon, 2002). The years with the largest sales were 1993 and 1995, when receipts reached 0.7% and 0.6% of GDP respectively. In the 1980s, many of the sales were of loss making companies and were made at a net cost to the government (Gamir, 2001). Hence net receipts from sales in the period 1985-94 were estimated at less than 0.5 million euros (Comín, 1995).

From 1996 until September 2002 under the PP government, gross receipts were around 29.5 billion euros. In 1997 and 1998 receipts peaked at 12 to 13 billion euros, or 2.7% of GDP, four to five times more than in any other year (CCP, 2002; Pampillon, 2002). Receipts from privatisation in 1997 and 1998 were among the highest in the OECD. Income from privatisations has been used to improve the government's finances (Arcas and Ruiz, 1999; Ezquiaga, 1998; Pampillon, 2002; Verges, 1998). Specifically, it was used to:

- finance other loss making public enterprises (such as the coal-mining company Hunosa) and their obligations under restructuring programmes;
- cover outstanding debts in the public enterprise sector (notably the historic debt of the former industrial holding company, the INI);
- cover labour severance costs and pension obligations; and
- finance redevelopment programmes for areas adversely effected by public sector restructuring.

Annual savings could be set against the income the government would have received from dividend payments. According to the government, in 1997 and 1998 reduction in costs more than compensated for the loss of dividend payments from the companies sold. A future dividend stream was lost, but so too was exposure to future public enterprise losses, thereby removing an element of instability from government finances. According to Hernandez (2000), business growth following privatisation resulted in government receipts from corporate taxation rising to exceed government revenue prior to privatisation. Overall, privatisation made a significant contribution to the rapid reduction of the public sector deficit. However, Verges (2001) noted that since the bulk of privatisations by value were of profitable firms, the medium or long-term effects on the state's current budget could be negative.

The impact of privatisation on public finance is an interesting and complex area and deserves further research. It is complicated by a variety of changes, including changing definitions, budgetary practices, public enterprise organisation, and the changing nature of privatised businesses. The following are associated with, but were not necessarily a consequence of, the privatisation programme:

- All major privatised companies were able to increase their profits in the first few years following privatisation.

- Some of the largest state enterprises left are also the largest loss-makers, e.g. the coal company Hunosa, the shipyards, the radio and TV broadcaster RTVE, and the railways RENFE. Thus, there are still large payments needed from the state budget.

- Net receipts from privatisation, especially in the 1980s, were significantly reduced by the costs of privatisation. The major privatisations of the 1990s generally involved profitable businesses and brought in large net revenues for the government.

- The outcome of economic development over the last decade has been for public finances to move on to a much sounder footing, a process that by the beginning of 2002 had led to Spanish debt obtaining the highest level of solvency ratings from the main international rating agencies.

- The budget deficit has been brought down to close to zero in 2001 and 2002.

**5. <u>Privatisation and competitive markets</u>.** The process of privatisation in Spain has been insufficient alone to create competition (Montes Gan and Petibo, 1998; Velarde, Garcia Delgado y Pedreno, 1995; Verges, 2001). Where a former public enterprise had a dominant market share, privatisation transferred that market share to private ownership. The government did not break up companies prior to sale, rather it tended to consolidate them (notably Endesa). In the oil market Repsol-YPF continues to control over 40% of all service stations, and dominates oil refining and the sale of liquefied (bottled) gas (Repsol-YPF 2002). In electricity Endesa controls some 45% of the generation market and over 40% of the supply market (Endesa, 2002). Telefonica dominates the telecommunications market with over 80% of the fixed-line market and close to half the mobile-phone market (CMT 2002). In tobacco Altadis retains a near monopoly. Crucially, privatisation did not involve the break-up of any of these businesses (although energy companies have been forced by the European Commission to unbundle their activities). In addition, the diversification of privatised businesses into new markets has created a complex web of cross-shareholdings and alliances (OECD, 1998a). Liberalisation is gradually creating competition. The framework for this process is being imposed by the European Commission as part of an EU-wide liberalisation policy, and then implemented in Spain through extensive regulatory reforms (Salmon, 2003 forthcoming).

In electricity, natural gas, bottled gas and telecommunications, there has been relatively little change in the market share of incumbent operators since privatisation (at least in their traditional supply areas). Most now operate in oligopoly markets as they did prior to privatisation. For example, prior to privatisation, Endesa shared the market in generation and supply principally with the private company Iberdrola. It continues to do so. Endesa has shed some 5% market share in generation through the sale of one of its subsidiaries, Viesgo, to an Italian utility. Apart from acquisitions, market entry has generally been a gradual process.

Apart from Gas Natural, which was required to divest itself of the gas transportation company Enagas, and similar divestments by industry incumbents in electricity and oil transportation companies, privatised companies have not been required to make divestments to create competition.

In the electricity sector, the major suppliers have been looking to sell their high tension transmission (transport) infrastructure as part of a process of disposals designed to reduce debts built up during rapid expansion and diversification. These assets look likely to be acquired by the privatised electricity grid company REE.

Incremental reforms have followed liberalisation of the main framework in energy and telecommunications. In electricity and natural gas the date for the introduction of freedom of choice

for all consumers has been brought forward to January 1, 2003. In electricity, natural gas and oil, the respective transportation companies (REE, Enagas and CLH) have become independent operators and their capital opened up to private and institutional investors. In telecommunications, Telefonica has gradually been required to provide improved access to infrastructure for other operators, notably opening the 'local loop'. There have also been moves to discriminate in favour of competitors in markets dominated by incumbent operators. In telecommunications, measures have been introduced discriminating against the main incumbent Telefonica, for example, preventing it from engaging in predatory pricing. Similarly, in the oil market, the two main incumbents, Repsol and Cepsa were prohibited from opening new service stations for a specified period of time. Many of these reforms have been linked to packages designed to create increased competition in an effort to reduce inflation.

Following privatisation, tariffs have fallen in energy and telecommunications. In the late 1990s and into 2000 profits rose as companies were able to take advantage of their strong market positions, cut costs and expand into new fast growing markets. In the last couple of years, profits have fallen back, mainly as a result of companies being squeezed by difficult operating conditions in both new product markets (e.g. information and communications technologies) and new geographic markets (e.g. Latin America), although large debts and tight regulatory conditions have also contributed.

**6. Delivery of key services.** Since privatisation has occurred within the context of markets that have been undergoing liberalisation, it is not possible to separate the impact of privatisation alone on the delivery (quality, reliability and cost) of key services. Prior to privatisation and liberalisation, postal services, power, telecommunications, transport and water supply were all available across Spain, generally at a uniform price. Where services were not heavily subsidised they were relatively expensive (eg. energy prices and international telephone calls) and service provision frequently poor (eg. in terms of the time required to install a telephone line). Services were generally not internationally competitive. Following privatisation and the accompanying liberalisation of markets, the delivery of all services is for the most part significantly better (Hernandez, 2000) and in many cases prices have fallen in real terms (notably in electricity and telecommunications, CMT 2002 and CNE 2002). Although privatised companies have concentrated their investments on the most profitable segments of markets, there is no evidence that services to low income groups or less profitable segments of markets have deteriorated (ibid). All the major privatised service providers are now internationally competitive.

**7. Privatisation and regulation.** In 1989 a new competition law (Ley 16/1989) brought Spain broadly into line with European law. Two bodies, the Competition Commission of the Ministry for the Economy (Servicio de Defensa de la Competencia) and the Competition Court (Tribunal de Defensa de la Competencia) are responsible for the enforcement of overall competition policy. Essentially, the Commission decides which cases to investigate and refers these to the Court. It also rules on the Court's decisions. Thus, despite the Court being given greater autonomy and resources in a strengthening of the competition framework under a new competition law passed in 1999, the system has been criticised for being too close to government and demonstrating too little transparency:

- Takeovers. Spanish law has meant that hostile take-overs have been practically impossible, even for most of the companies quoted on the Madrid Stock Exchange, because of the widespread use of various forms of protection. The government continues to exercise a veto on take-overs through its control of the Commission and through the use of a 'golden share' in leading privatised companies (Endesa, Indra, Repsol-YPF and Telefonica). As part of the 2003 Budget legislation a new law on the framework for acquisitions will be introduced in 2003 and Spain will have to conform to any agreed new Europe-wide take-over rules.

- Regulation. Outside financial markets, there are three sector regulators covering Energy (Comision Nacional de Energia, CNE), Telecommunications, Audiovisual and Internet Communications (Comision del Mercado de las Telecomunicaciones, CMT) and Tobacco

(Comisionado para el Mercado de Tabaco, CMT). The overall competition authorities and regulators have faced criticisms of insufficient autonomy and transparency in decision making. In several cases proposed mergers have been decided by the government rather than the regulator. Despite these criticisms, sector regulators have ensured that prices have fallen significantly, services have generally improved, markets have gradually been opened to competition and privatised companies with dominant market positions have been restrained from engaging in anti-competitive practices. The one example of service breakdown has been in the electricity supply sector, where some supply interruptions have been experienced. Privatisation removes the government from direct control over investment. Hence, the government can only produce indicative plans. The regulatory regime must then provide adequate incentives for companies to invest while protecting consumers and ensuring that service commitments are adhered to. There is a danger of over-regulation which, along with continuous regulatory change, creates regulatory risk that can threaten investment.

- Corporate governance. Since the accounting scandals in the United States in 2002 the quality of corporate governance in all publicly quoted companies in Spain, as elsewhere, has been under the spotlight. In general the existing corporate governance of privatised companies is judged acceptable by international financial markets and by the regulators (OECD, 1998b and 2001). Spanish companies will continue to conform to any new international standards.

The privatised industries have various regulatory frameworks, methods for setting tariffs and commitments of the private providers towards new investment:

**Telecommunications.** Framework legislation for the telecommunications industry is provided by the Spanish Telecommunications Law (Ley 31/1997), the General Telecommunications Law of 1998 (Ley 11/98) and by subsequent legislation. The market regulator is the Comision del Mercado de las Telecomunicaciones (CMT). Tariff and other operating restrictions have been placed on dominant operators (those with over 25% share in any one market). In fixed-line services this applies only to Telefonica, in mobile phones to Telefonica and Vodafone. Tariffs to consumers for these operators are set by the government (as in other sectors, the Ministry for Economic Affairs). A price cap was introduced in August 2000. In 2003 prices for fixed-line telephony may not rise by more than 2% (from 2003 price rises will be linked to the budgeted retail price inflation rate). The government intends to stop determining tariffs from the beginning of 2005 as long as there is effective competition by that date. According to the CMT fixed-line telecommunications prices have fallen 47% since liberalisation (CMT 2002, p.27) as a result of regulatory control and competition.

**Electricity.** There has been a long process of reform in the electricity sector. A law passed in 1987 (Ley Marco Legal Estable) established a new regulatory regime based on standard costs that would provide companies incentives to improve their efficiency. A new liberalisation law was passed in 1994 (Ley de Ordenacion del Sistema Electrico Nacional), followed by an agreement between the government and the electricity industry in 1996 over the framework for the future regulation of the electricity supply industry (Protocolo Eléctrico). The current structure and organisation of the Spanish electricity supply industry is described in the Spanish Electricity Industry Act, 1997 (Ley de Ordenacion del Sector Electrico, Ley 54/1997), which entered into force on January 1, 1998, together with further legislation passed since that date. Under the 1997 Act production and marketing are not regulated, economic and technical management, transport and distribution are regulated. Initially only very large consumers (consumption over 15 GWh a year, representing around 1% of the market) were free to chose their supplier and make bilateral contracts with dealers or generators. There followed a phased opening of the market, which was accelerated from the initial schedule, such that by January 1, 2003 all consumers will be free to chose supplier. The system regulator is the CNE (Comision Nacional de Energia).

There is a General Tariff System, with different tariffs for different types of end users (high, medium and low tension supplies), which is the same throughout the national territory. The calculation of

tariffs is complex. End user tariffs are based on the cost of generating electricity, charges for transmission and distribution, trading costs, the system's permanent costs, costs of diversification and security of supply. The inclusion in the electricity tariff of payments to cover the costs of transition to a competitive market (CTCs) and energy policy costs are a substantial burden on the electricity consumer. A more detailed statement can be found in (OECD 1999, p.28) from which the following is taken:

'A law passed in 1987 introduced a cost pooling mechanism to compensate for the widely divergent costs between companies. 'Standard' costs have been calculated for the overall system, including depreciation, operating costs, fuel costs, interest costs, etc. The costs were calculated every year by the Ministry based on a set of assumptions about economic and financial parameters such as the return on capital, inflation and operating costs. The Ministry calculates a tariff for all end users, which results in some utilities receiving more revenue than their standard costs, others less.

As revenues received by a particular utility are not matched to the costs of the utility, there is a complex revenue rebalancing process using a method set out by the Ministry and administered by the CNE. This process ensures that utilities receiving excess revenue transfer this excess to those utilities receiving insufficient revenues. It is also used for revenue reallocation related to energy policy costs.

The use of standard costs gives companies incentives to reduce their costs as the revenues they are entitled to receive are fixed by the standard cost formula and they are allowed to keep any cost savings they can make. As generation is no longer regulated since the 1997 law, only network tariffs are based on the standard cost formula.

Retail and network tariffs are set by Royal Decree. Normally the CNE is given a draft proposal for review and advice before the Ministry finalises it. Tariffs are to be the same throughout the national territory. The law imposes separate charges for 'permanent costs of the system' and supply diversification and security. Electricity purchasers are subject to value added tax as well as local or regional taxes.

Rate reductions were initially set out in the 1996 Protocol between the electricity utilities and the government but rates have been reduced further.'

At the beginning of the process of liberalisation (in 1996) it was agreed that there would be a progressive reduction in tariffs determined each year. According to the suppliers the price of electricity sold under the tariff in 2001 was 17% cheaper than in 1996 and 30% cheaper in real terms. In September 2002, the tariff framework for the coming years was set to involve a maximum annual increase of 2%. Due to the government's direct involvement, tariffs have become political in terms of the government's commitments to consumers, their industrial policy, and also as a tool of economic management used to counter inflationary pressure. From the suppliers side, the incentive to invest is determined by the likely evolution of the tariff and their own costs. Hence, as suppliers have come under greater cost pressure they have sought a less strict tariff regime.

**Gas.** The gas market is regulated by the Hydrocarbon Law (Ley 34/1998) and subsequent legislation. The tariff to consumers, and access charges to infrastructure, for all forms of gas is set by the government. For calculating the tariff to consumers the government uses a formula based on the cost of the raw material (CNE 2002).

**Oil.** In the oil market prices were regulated by the government but are now deregulated.

**Water.** Responsibilities for managing water supplies are shared between the state, the regional governments, local authorities and some private utilities. Since the end of the nineteenth century the Spanish government has supported river basin authorities (Confederaciones Hidrográficas, e.g. Ebro,

Duero, Guadalquivir, Segura and Tajo). The regional government of Madrid owns the company Canal de Isabel II which supplies water in this region. These water authorities have representatives of the regional government, local authorities and water users on their boards. They are mainly responsible for the public works associated with the development of water supplies (building dams, reservoirs and water channels, river flood protection, sewerage disposal facilities and supplying water to the local authorities). They work closely with the local authorities who are the responsible political bodies for ensuring adequate water supplies and adequate sewerage disposal systems. Some local authority supplies are now managed by private companies under contract. There are also two major private water supply companies: Corporación Agbar is the largest water company in Spain (it has an indefinite concession for the supply of water in the city of Barcelona, concessions to supply water in other parts of the Barcelona metropolitan area and contracts with some other local authorities elsewhere in Spain); and Aguas de Valencia, which serves Valencia).

**Consumer Protection.** Consumer protection is provided through the elected government's control over tariffs and regulated areas of supply, and through the sector regulators (in energy, financial services, telecommunications and tobacco) and consumer groups. The latter two can report restrictive practices to the Competition Authority (Servicio de Defensa de la Competencia, a government agency), which may refer cases to the Competition Court (Tribunal de Defensa de la Competencia) for investigation. For example, in November 2002 the SDC referred a case to the Tribunal involving alleged price fixing on the electricity wholesale market by the four major electricity utilities.

**Investment incentives.** Where the government is setting tariffs, it must balance its commitment to consumers on prices with a regime that provides adequate incentives for companies to invest. In general this occurs through on-going dialogue. There are specific incentives to achieve specific targets. For example, there are incentives for using domestic coal in electricity generation and for developing renewable energy sources.

The commitments of the private providers towards new investment varies between sectors and specific privatisations. Where companies have been privatised through direct sales, each sale has been accompanied by a specific commitment on behalf of the acquiring company towards investment. Where companies have public service obligations or they operate under licence they also have an investment obligation. For example, under the telecommunications legislation Telefonica is designated as the universal service provider (USP) in fixed-line telephony, at least until 2005. Licences for mobile phones and 3G services have also been accompanied by investment requirements (which for 3G licences have recently been relaxed).

**Post-privatisation review mechanisms.** There are no known review mechanisms outside of that undertaken by the Privatisation Consultative Committee (Consejo Consultivo de Pivatizaciones, CCP) on the privatisation process itself. Further oversight is provided by sector regulators, the competition authorities and the financial markets. Presumably, where privatisations have included specific commitments the privatisation agency (recently SEPI) and the relevant department of the government (Ministry for Economic Affairs) monitor implementation.

There are no known examples of private providers failing to meet investment or performance commitments. If there is a breach of contract firms are fined for failing to meet regulator requirements. Following privatisation public subsidies are generally prohibited.

## CONCLUSION

The privatisation process has been judged by most writers in Spain as having delivered substantial benefits to consumers, workers, businesses and the government (Cuervo, 1997; Gamir, 1999; Hernandez, 2000), with critical comment coming largely from the opposition parties (Berenguer, 2002; Mota, 1998):

- Although substantial injections of public funds were often needed prior to the sale of companies, possible future liabilities were eliminated and the state received substantial gross receipts, thanks largely to the main disposal of assets occurring during a period of strong domestic and international economic growth and buoyant stock markets. Receipts from privatisation contributed to the reduction of the public sector deficit, helping to enable Spain to qualify for entry to the 'euro-area'.

- Following privatisation, but not solely due to it, companies have been transformed from bureaucratic, inefficient and domestically oriented businesses into international competitive ones. Part of this success has been built on the decision to maintain national market dominant companies intact during the privatisation process. This gave these companies a strong domestic base from which to build international markets and provided them with a cushion in the domestic market on which they could strengthen their competitiveness while markets were gradually liberalised. Experience of the privatisation process also gave Spanish privatised companies an advantage in assessing public assets being sold in other markets.

However, the privatisation process is not without problems:

- Although privatisation provided opportunities for foreign companies to acquire Spanish assets, the authorities in Spain were careful to ensure that a number of powerful national champions were created, capable of competing on the international stage.

- The failure to break up monopolies prior to privatisation, however, resulted in privatisation alone having little direct impact on the creation of competitive markets.

## FURTHER RESEARCH

Further research and investigation where there are gaps in the literature would enhance this study:

- **Privatisation methods.** Enormous experience has been gained in privatisation methods across virtually the whole range of economic activities. A more detailed summary of these methods would enhance this element of the study.

- **Company experience.** The post-privatisation experience of the major high-profile companies is well known. However, that of the many other companies privatised has received less comment. An assessment of their experience would provide a more rounded picture of the impact of privatisation, as would an examination of the internal reorganisation of businesses following privatisation.

- **Services.** Railways (and transport generally), the postal service, energy and water are key service areas where a variety of organisational forms are being developed. Further evaluation of these would contribute to the assessment of successful and unsuccessful forms of privatisation and of alternative models.

- **Liberalisation.** The success of privatisation in bringing about welfare benefits is closely linked to liberalisation. A fuller picture of liberalisation would therefore help put privatisation in context.

- **Net receipts.** Although the gross receipts from privatisation are known, net receipts (allowing for the costs of privatisation) are less known.

- **Income distribution and poverty.** There is little direct evidence on the impact of privatisation on income distribution and poverty.

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# PRIVATISATION IN ZAMBIA

## LEGISLATION AND METHODS

In the early 1990s, the Zambian government embarked on one of the fastest rates of privatisation in Africa winning donor community praise (Kayizzi-Mugerwa, 2001). While in other African countries, privatisation was invariably undertaken as part of the conditionality attached to economic reform, Zambia was one of the few countries to elect a party which included privatisation in its manifesto. However, the privatisation of state-owned enterprises (SOEs) pursued by the Zambian government since 1992 has been subject to a number of conflicting evaluations. As Craig (2000) observes, for some it is a 'model' of success which stands as an example to other developing countries, while for others it is a 'deeply flawed' experience which allowed for the corrupt acquisition of assets by those linked to the ruling party.

### Economic Development and State Ownership

Until recently, Zambia had a vast state enterprise sector which accounted for over 80% of the economy (Fundanga and Mwaba, 2000; Kenny, 2000; Cook and Kirkpatrick, 1988). This sector largely emerged during the first decade of independence between 1964 and 1974 (Chisanga, 2002; Chiwele, 2000; Fundanga and Mwaba, 1997; Kani, 2000; Mulenga, 2000; Craig, 2000). During this period, the immediate post-independence United National Independence Party (UNIP) government pursued a policy of import substitution industrialisation (ISI) in which the state entered into joint ventures with foreign corporations to establish new industries. In addition, between 1968 and 1972, the government, through the Mulungushi and Matero Reforms, enacted a programme of nationalisation which saw the state acquire a controlling interest in many of the most important private sector businesses, including the mines (Chisanga, 2002; Bwalya, 2001; Chiwele, 2000; Fundanga and Mwaba, 1997; Kani, 2000; Craig, 2000; Sandbrook, 1988). As a result, at the end of the 1970s, there was virtually complete control of the economy by the state under a hierarchy of state holding companies, at the apex of which was the Zambia Industrial and Mining Corporation (ZIMCO).

By the mid-1970s, the flaws in Zambia's strategy of state ownership had started to show (Chisanga, 2002; Cooper, 2002; Chiwele, 2000; Kani, 2000; Mulenga, 2000; Craig, 2000; Fundanga and Mwaba, 1997). The onset of the 1973 oil crisis, coupled with the collapse of the copper price, adversely affected the fiscal position of the government. Amidst the growing debt crisis and worsening fiscal performance, especially in the 1980s, capacity utilisation in the SOEs, which were largely dependent on government subsidies, declined to around or less than 30% (Hamasaka, 2002; Bwalya, 2001; Craig, 2000; Mulenga, 2000). Much of this literature suggests that the majority of SOEs were on the verge of collapse due to excessive debt, declining productivity, under-investment, loss of market share from increased competition, and lack of access to working capital. Although this period saw a gradual return to market-based reforms as the basis for economic management, it was not until 1992, following a change of government in which UNIP was replaced by the reformist Movement for Multiparty Democracy (MMD), that a more consistent market-oriented economic policy was introduced.

Since 1992, the MMD government has undertaken what many analysts describe as a 'radical' economic reform programme (see Bwalya, 2001; Chiwele, 2000; Kani, 2000; Kazziya-Mugerwa, 2001; Kenny 2000; Pangaea, 2000; Fundanga and Mwaba, 1997; White, 1997). A critical element of these reforms was to rollback the role of the state in economic management. It was hoped that the promotion of a private sector-driven economy would lead to an increase in investments, job creation

and poverty reduction. The government's main tool for enhancing private sector participation in the economy has involved economic liberalisation and regulatory reforms.

## Methods and Objectives

In the Zambian context, privatisation has largely been seen as the transfer of assets from the public sector to the private sector. Other forms of privatisation, such as contracting out, deregulation and the transfer of service provision from the public to the private sector, have not been used. The key objectives of privatisation in Zambia can be summarised as:

- reducing state control of the economy;
- public finance rationalisation;
- economic efficiency;
- broadening ownership; and
- attracting FDI.

**Institutional framework for privatisation.** Privatisation in Zambia was first adopted as policy by the former UNIP government in 1990 (Fundanga and Mwaba, 1997). However, it was not until a change of government in late 1991 that the process really got under way. In 1992, just six months after coming to power, the MMD Government passed the Privatisation Act (now known as Chapter 386 of the Laws of Zambia). This Act established the Zambia Privatisation Agency (hereafter 'ZPA' or the 'agency') as the sole institution responsible for the divestiture of state enterprises. ZPA was to be governed by a Board of Directors to be drawn largely from the private sector. The agency was granted autonomy to determine how enterprises were to be privatised and the prices to be paid for them. This allowed the ZPA to undertake its work free of political interference (Chisanga, 2002; Posthumus, 2000; Campbell, White and Bhatia, 1988). The government also legislated in a number of related areas to support the privatisation process (see Chisanga, 2002; Craig, 2000; Fundanga and Mwaba, 2000; Campbell, White and Bhatia, 1998). In addition, the state holding company -- ZIMCO -- was abolished as it was seen as constraining the privatisation process (Craig, 2000; Fundanga and Mwaba, 1997; World Bank 1992).

Following the creation of this institutional framework, the MMD launched a comprehensive privatisation programme. A Divestiture (De-nationalisation) Sequence Plan was unveiled for the privatisation of an initial 144 SOEs, including the Zambia Consolidated Copper Mines (ZCCM), one of the biggest companies in sub-Saharan Africa (SSA) (Craig, 2000). This comprised seven tranches, the first of which contained 20 mainly small companies which could be easily analysed and disposed of through trade sales. After what many observers saw as a slow start between 1992 and 1993, there was a very marked increase in the number, size and value of the privatisation transactions from 1995 onwards (Fundanga and Mwaba, 2000; EIU, 1994-1999; Bennell, 1997).

A recent estimate by Hamasaka (2002) indicates that, as at August 31, 2002, the Zambia Privatisation Agency (ZPA) had privatised 256 companies/units out of a working portfolio of 280 units. According to Craig (2001, 2000), this included 70% of enterprises rated 'large' and over 85% of enterprises classified as 'medium' or 'small'.

The main conclusion of virtually all research on privatisation in Zambia is that the programme has been highly successful, at least in the initial stages (Chisanga, 2002; Kayizzi-Mugerwa, 2001; Chiwele, 2000; Campbell, White and Bhatia, 1998; IRIS, 1998; World Bank, 1995). Chiwele asserts that Zambia's privatisation programme is perhaps the best in the developing world. Other analysts

tend to concur (Chisanga, 2002; Kani, 2000; World Bank, 1996). However, the government has excluded from privatisation large utility companies, especially those engaged in sectors such as energy; communications; transport; and finance (Chisanga, 2002; Craig, 2000; Fundanga and Mwaba, 1997).

**Privatisation of Utilities and Monopolies and Regulation**

Although there has not been any divestiture of the utilities, mostly monopolies such as electricity company -- ZESCO -- and to some extent telecommucations, work is advanced on the privatisation of Zamtel, the telecommuication utility and the state-owned Zambia National Commercial Bank (ZNCB). The state intends to sell its majority shareholding in these companies to the private sector. Other utilities earmarked for privatisation are Zambia Railways, Mulobezi Railways and Zampost. Only the Copperbelt Power Company, which distributes power on the Copperbelt, has been privatised. How to treat these firms both during divestiture and after becomes important. As Fundanga and Mwaaba (1997) observe, the problem will be how the economy will benefit from this privatisation without suffering from monopoly pricing. Other concerns relate to the distributional impact of the privatisation of utilities on the poor and rural areas (see recommendations for further research). Orthodox privatisation literature suggests that welfare gains from the privatisation policy can be maximised where the enterprise is in a competitive market.

To protect consumers from possible monopoly abuse, whether through excessive prices or poor or unsafe service, the government has begun to establish regulatory arrangements for public utilities, based on the industrilialised country model—the main utilities have specific regulatory bodies. An IMF, World Bank and Government of Zambia policy framework paper (1999) notes that public utility prices need to be set at levels that provide adequate returns on capital and facilitate efficiency and investment, while ensuring that enterprises do not exploit their monopoly positions. The regulatory bodies established by the government include the Energy Regulation Board (ERB), the Communication Authority and the Competition Commisssion. The ERB, which was established in 1997, has the independent power to regulate electricity prices, while the Communication Authority is supposed to regulate all service providers in the telecommunication sector. The Competition Commission is supposed to regulate competition in other monopoly markets—such as cement distribution, sugar production and beer production. If the government decided to privatise Zesco, Zamtel and other monopolies and regulations were found to be inadequate, these bodies would be expected to develop other standards befitting the new circumstances.

In the water sector, the government has commercialised water supply and sanitation service provision and devolved the responsibility to the local authorities (Chanda, 2000). Various options for private sector participation have been given. Realising that water supply and sanitation service provision is a natural monopoly, the government established the National Water Supply and Sanitation Council (NWASCO) under the Water Supply and Sanitation Act of 1997, to regulate all water and sanitation service providers in the country, for improved efficiency and sustainability. This major policy shift by the government is as a result of many years of failure to provide a good and adequate service to the Zambian population. However, water supply and sanitation service provision is still very low in rural areas and deficient in peri-urban areas.

Many of these regulatory bodies have, however, yet to rationalise their operations. The process is institutionally demanding in an environment—such as Zambia's -- which is characterised by inadequate financial resources, skill scarcity and weak institutional capacity. Some donors such as USAID are supporting some of these bodies. But eventually all of them will have to be funded from meagre local resources.

## Privatisation Process

The Zambia Privatisation Agency selected a group of companies to be privatised within a given period of time. The first tranche of very small companies were selected to test how the process of privatisation could be implemented. Given the absence of a well-developed capital market, the sale of SOEs has been the major mode of privatisation (Chisanga, 2002; Fundanga and Mwaba, 1997). The Zambia Privatisation Act provides for two types of payment for the sale of companies; deferred payment and cash sale. Within the Privatisation Act, provision is made for current minority shareholders in parastatals to exercise pre-emptive rights. By October 1996, fourteen companies had been sold on the basis of pre-emptive rights:

- Liquidation. Another method that ZPA has employed to end state participation in the economy has been liquidation. This method is preferred where the company is so run down that it would be difficult to turn it into a going concern or to find a buyer. Fifteen companies were liquidated under this procedure.

- Public participation. A further important issue in the privatisation programme in Zambia has been how to increase public participation in ownership of the enterprises, given the low levels of incomes and savings which virtually excluded most of the local Zambians from participating in the acquisition of property (Chisanga, 2002; Craig, 2000; Fundanga and Mwaba observe (1997). In order to address this issue, the Privatisation Act provided for the creation of the Zambia Privatisation Trust Fund (ZITF) in 1994.

- Management buy-out. There has also been a number of companies that have been disposed of through the management buy-out approach. Given that management buy-out teams have the right to use the deferred payment method, a major weakness that emerged is that many corporate bidders (who are otherwise not allowed to participate in management buy outs) are known to have entered into joint ventures with management buy-out teams primarily to benefit from deferred payments terms.

**Purchaser characteristics**. As Craig (2001, 2000) and Bennell (1997) observe, it is frequently not possible to determine the new owners of the newly privatised firms. Available evidence suggests that in Zambia the number of genuinely African owners is somewhat higher than in other African countries. By December 1995, it was estimated that over 40% of sales went to local buyers (Bennell, 1997: 1793), rising to over 70% by 1999 (Craig, 2000). According to Bennell, this large proportion of indigenous owners could be attributed to the large number of employee and management buy-outs and the fragmentation of many SOEs into smaller units, especially in the agriculture and food processing sectors. An alternative explanation is that foreign capital was interested in only a limited number of the enterprises offered for sale in the Zambian privatisation programme (Craig, 2000). The World Bank (1996) cites Zambia's fragile economic situation as the main reason (Bayliss, 2002, 2001).

Most of the enterprises sold to local Zambians were small companies, such as dry-cleaning companies, bakeries, farms, hotels and shops. Craig (2000) attributes this to lack of the necessary investment and technical skills required to manage large enterprises among the indigenous business class. Thus, major companies have been purchased by multinationals (MNCs).

**Initial success**. While Zambia's privatisation programme has been praised in many quarters, probably the most influential assessment has come from the 1998 World Bank study, "Privatisation in Africa", authored by Campbell-White and Bhatia. This study, which views Zambia's privatisation programme as a success story and model to other developing countries, cites a number of reasons for the country's success. A private sector assessment study by IRIS (1998) reached a similar conclusion.

Other sources tend to concur with these views (see Chisanga, 2002; Kayizzi-Mugerwa, 2001; Bennell, 1997; Posthumus, 2000). There are a number of key success factors:

- Government commitment. The MMD government was elected on a platform of strong support for private enterprise. Immediately after assuming office, President Chiluba made it clear that all parastatals would be put up for sale. This resulted in serious commitment to privatisation (Craig, 2001, 2000; Kayizzi-Mugerwa, 2001; Campbell, White and Bhatia, 1998). Multi-party elections allowed the MMD to distance itself from the statist policies of its predecessor (Bennell, 1997), while its dominant parliamentary majority allowed it to pass new legislation on privatisation quickly (Chisanga, 2002). That the government was able to stand up to the miners and other domestic groups on the issue of privatisation also enhanced its reputation in the eyes of investors (Kayizzi-Mugerwa, 2001).

- Appropriate legislation. In addition to the Zambia Privatisation Act and the creation of the ZPA a large number of legislative amendments were made in order to make it possible to sell some of the state-owned enterprises, most of which also owned other assets, including land and residential properties.

- The role of multilateral donors in programme design and management. Much of the literature suggests that, in the early stages, the Zambia Privatization Agency (ZPA) received assistance from multilateral donors, especially the World Bank and the United Nations Development Programme (UNDP) (see Campbell-White and Bhatia, 1998; Fundanga and Mwaba, 1997). For example, UNDP provided the financing for technical work required to effect most of the legislative changes under a Privatization and Industrial Reform Programme. Apart from the UNDP support, the World Bank, in June 1992, provided assistance through the Privatization and Industrial Reform Credit. Other multilateral donors such as the EU are providing support to private sector development in general. A lot of support to ZPA also came through bilateral agencies, such as, USAID, ODA, GTZ, NORAD, and DANIDA. This support was mainly in the form of provision of technical experts to assist ZPA in the technical evaluation of companies to be privatized, provision of equipment, such as, computers and the training of personnel. The ZPA also benefited from capacity building workshops and short courses.

- Transparency of procedures. In the literature, there is general agreement that the privatisation process in the early 1990s in Zambia was characterised by transparency (Posthumus, 2000; Campbell, White and Bhatia, 1998). A serious attempt was also made to inform the public about the programme and to encourage Zambian participation.

According to Kayizzi-Mugerwa (2001), these attributes indicate that in the early 1990s, Zambia had been able to quickly reach 'best practice' in the process of privatisation, while at the same time garnering donor support. In the view of Campbell-White and Bhatia, it is this 'best practice' that created the basis for the successful divestiture and provided a model for other countries seeking to pursue a policy of privatisation. Given this success in the early stages, the question was whether the government would be able to sustain its privatisation programme as more politically sensitive companies fell due for divestment.

**ZCCM problems.** The privatisation of Zambia Consolidated Copper Mines (ZCCM) is illustrative here. In the Copperbelt -- Zambia's copper mining region -- ZCCM was more than a company (Chisanga, 2002; Kayizzi-Mugerwa, 2001; Posthumus, 2000). According to Kayizzi-Mugerwa (2001), "it was a state within a state, with its own schools, hospitals and farms". ZCCM accounted for around 10% of GDP and over 90% of foreign exchange earnings (Craig, 2001, 2000). There is an almost unanimous consensus that ZCCM posed the greatest challenge to privatisation in Zambia (Chisanga, 2002; Kayizzi-Mugerwa, 2001; van de Walle, 2001; Chiwele, 2000; Craig, 2001, 2000; Kani, 2000; Posthumus, 2000; Bennell, 1997):

- Although the government announced its intention to sell the mines in 1996 and assured the donor community that the sale of this company would be rapid, the size of the assets as well as the political symbolism of its ownership overwhelmed first attempts to privatise it (Chisanga, 2002; Kayizzi-Mugerwa, 2001; van de Walle, 2001). Privatisation was delayed for another four years.

- While the government was negotiating with the first set of bidders, the Asian financial crisis led to a sharp decline in copper prices. The potential buyers either lost interest or wanted to renegotiate. Accusations of corruption and rent-seeking among politicians and senior state managers tended to discourage potential buyers. Negotiations were stalled by reports of asset-stripping. The appointment of a 'special negotiating team' by President Chiluba, in clear violation of the Privatisation Act, raised suspicions. No real progress was made under this committee. Critics accuse the committee of working slowly and rejecting two excellent bids, including one from the Kafue consortium comprising major mining houses – Anglo Vaal, Noranda and Phelp Dodge (Sanderson, 2002 and Poshthumus, 2000).

- Much of the literature suggests that the failure to divest ZCCM, coupled with charges of corruption and asset stripping, convinced donors that their aid embargo needed to be tightened (Kayizzi-Mugerwa, 2001; Luandal, 2001; van de Walle, 2001; Posthumus, 2000). The resolve by donors to condition any increases in aid on an agreement to sell ZCCM somewhat distorted the market price of the mines to the advantage of Anglo-American, which was bidding for ZCCM. Realising that the sale of ZCCM was now more than just a market proposition and had become a precondition for continued donor assistance to Zambia, Anglo was now intent on pushing for a lower price. In January 1999, the major donors withheld some 530 million dollars until ZCCM was privatised (Posthumus, 2000).

- In 2000, donor-driven conditionality allowed Anglo American to buy Konkola, Nchanga and Nampundwe operations for a cash payment of 30 million dollars up front and 60 million dollars in deferred payment. ZCCM's debts and the poor state of many of its assets, encouraged many would be-buyers to push for a bargain price (EIU, 1998-1999). Mine closures had become inevitable. The government had no choice but to beg Anglo American and Quantum to rescue the large mines on terms that are generally described as 'less favourable' to Zambia than had been offered by the Kafue consortium. Anglo was also expected, pending the fulfilment of certain financial and other criteria, to invest some 730 million dollars to develop, among others, the Konkola Deep Mining Project upon which most of Zambia's future as a copper producing country is said to hinge.

Several analysts contend that the Anglo-American deal looks 'meagre' when compared to the June 1997 bid by the Kafue Consortium for roughly the same number of assets, with the exception of Konkola (Sanderson, 2002; Posthumus, 2000). This consortium had pledged well over 1 billion dollars in cash, debt resumption and committed or expected investment (Posthumus, 2000). This comparison is only intended to show the concern of many analysts in Zambia who feel that the government should have gone for the Kafue Consortium bid. Many activitists, including parliamentary deputies, attacked the terms of Anglo's purchase of Nchanga, Nampundwe and the Konkola Deep Mining Project (AC Vol 42 No 14). Other activists, especially an organisation called Citizens for a Better Environment (CBE), accused Anglo, as the main minority shareholder in ZCCM, of imposing conditions which caused delays in privatising the mines when fresh capital was needed to stem the financial bleeding of the mining conglomerate (Ibid.).

The government also offered more incentives to Anglo-American than other mining companies. As Africa Confidential (Vol 42 No 14) contends, Anglo's concessions in Zambia were 'extra generous'. They included a cut in corporate tax from 35% to 25%; exemption from tax on profits for 20 years (not the usual ten years); a drop in mineral royalty rate from 2% to 0.6%; significant environmental indemnities and a reduced power tariff (AC Vol 42 No 14; AC Vol 41 No 16). The issue of

environmental indemnities is significant here. The environment on the Copperbelt has been seriously affected by copper mining. At present, most mining companies have been exempted from complying with environmental regulations for 15 years, while for Anglo it was 20 years (AC Vol. 42 No 14). Attempts to take these companies to court for failure to comply with environmental regulations have proved difficult (AC Vol 42 No 14). Although Anglo issued an Environmental Management Plan for consultation, activists, including CBE, accused the company of having broken the OECD's code on, among other things, environmental protection. CBE complained to the UK Department of Trade and Industry (DTI). These complaints are mirrored in the report to the United Nations (UN) by Oxford University's Rights and Accountability in Development (RAID) Project (see Kenny in this report). However, Anglo's Social Plan was better than that of most mining companies. Apart from ZCCM, a number of constraints have made it difficult for the government to sustain its initial success in the privatisation of large SOEs, especially public utilities.

## Obstacles to Privatisation

Although the privatisation programme in Zambia is still widely seen as 'rapid' 'honest', and 'successful' at the international level, recent literature, while accepting some of the initial successes, views the programme as deeply flawed. Craig casts doubt on some of the rating criteria employed by Campbell, White and Bhatia (1998). This is supported by other independent analysts. In this more recent literature, it is generally argued that the ZPA has had difficulties in meeting its divestiture goals, especially in the privatisation of large SOEs, because of a number of factors:

- **Politics of privatisation.** Although the ZPA claims that political leaders have no advantage in the privatisation process, many independent analysts observe that the privatisation process in Zambia has been disturbed by a considerable amount of political interference (Chisanga, 2002; Kayizzi-Mugerwa, 2001; Lundahl, 2001 Craig, 2000; Posthumus, 2000). It is argued that politicians have used their influence to manipulate the process, with companies transferred directly to them (Chisanga, 2002; Kayizzi-Mugerwa, 2001; Craig, 2000; SARPN, 2000) in line with the positive theory of privatisation, which suggests that, since bureaucrats and politicians benefit from state control, they only undertake divestments when they can be sufficiently compensated for their loss of rents. The sale of ZCCM is illustrative here. Many independent observers argue that rent-seeking behaviour and corruption on the part of politicians and senior state managers resulted in bad contract design and implementation (Mulenga, 2002; van de Walle, 2001; Craig, 2000). This casts some doubt on arguments of quality programme design and management, which White-Campbell and Bhatia cite.

- **Diminished transparency.** Unlike the earlier stages, as the privatisation process progressed, little information was given to the public on the sale of large SOEs (Chisanga, 2002; Craig, 2000). Again the case of ZCCM is illustrative here. In clear violation of the Privatisation Act, Chiluba appointed a special negotiating team. The opaque manner in which the team was appointed and its operations raised serious suspicion (Chisanga, 2002; Sanderson, 2002; van de Walle, 2001; Posthumus, 2000; IRIS, 1998). Many analysts have commented that transparency was not followed during the privatisation of Roan Antelope Mining Corporation of Zambia (RAMCOZ) (see Chisanga, 2002). Arguably, this reflects weaknesses in legislation and implementation of the Privatisation Act (Posthumus, 2000).

- **Rising public concern.** NGOs, trade unions, professional associations, enterprise associations and opposition parties have raised serious concerns over the welfare consequences of the privatisation process (see Chigunta, Chisanga and Masiye, 1998). While the Privatisation Act provided for their representation on the ZPA board, vacancies for civil society associations on the board were not filled for several years (Craig, 2000). This raises some questions about the governance of the ZPA. Media reports also indicate that there is growing public opposition to the proposed privatisation of public utilities such as the Zambia

Electricity Supply Corporation (ZESCO), Zambia Telecommunications (ZAMTEL) and the state-owned Zambia National Commercial Bank (ZNCB). Recently, parliament rejected the proposed privatisation of ZNCB (The Zambia Daily Mail, December 6, 2002). The new Republican President, Levy Mwanawasa, in a letter to his finance minister, has also signalled his opposition to the proposed privatisation of the remaining parastatals (The Post, December 6, 2002). The prevailing view is that privatisation of these enterprises might lead to the negligence of rural areas and the poor (see Chisanga, 2002; Mwetwa, 2002; Bayliss 2001, 2000). However, there is little or no opposition to the proposed privatisation of other state monopolies such as Zambia Railways, Zambia National Oil Company and Indeni Oil Refinery.

Overall, Bennell (1987) argues that the successful sale of SOEs is dependent upon government credibility, transactions transparency, prospective investor and government valuations, and knowledge of future privatisation. Those SOEs that have not attracted much interest from donors, such as Zambia Airways and assembly plants, have been liquidated. Others, such as Nitrogen Chemicals and Kafue Textiles, are surviving on meagre government subsidies and are operating at very low capacity, while attempts to privatise the Zambia State Insurance Corporation (ZSIC) have failed because of the cost of retrenchment.

## The Financial Sector

The formal financial sector in Zambia comprises a total of 14 operating registered commercial banks and numerous non-bank financial institutions (NBFIs). The sector plays a major role in the Zambian economy, contributing about 8.5% and 8.6% to GDP and formal employment, respectively (Ndulo, 2000). Although an attempt to reform the sector started in the late 1980s, serious reforms were only started in 1992 and completed in 1996. Despite a high number of players in the market due to financial sector liberalisation, the market is still dominated by commercial banking. Commercial banking is also dominated by five large banks that by December 1997 held 77% of the deposits, while the rest of the then sixteen banks held only 23% of the deposits. This monopolisation of banking means that the quality of financial services has not significantly improved (Ndulo, 2000). Lending to local entrepreneurs or small and medium enterprises (SMEs) is still negligible, waiting time is still long, operating costs are high and bank tariffs and commissions are still very high. Non-performing loans continue to be high and are highest amongst local banks. The sector also experienced a series of closures of local banks between 1995 and 1997, when about eight banks closed. The major reasons were found to be under-capitalisation, high levels of non-performing loans and contagion. Positive developments arising from liberalisation include the presence of automated teller machines (ATMs), charge cards, and interest bearing accounts, foreign service transactions and electronic banking. Major sources of income for commercial banking are interest income, securities and commissions.

The liberalisation of the financial sector has also led to a rapid growth in private non-bank financial institutions. As of December 1996, there were thirty-three NBFI's supervised by the Central Bank. Most of these NBFls raise their funds from the public either through subscriptions for shares, taking deposits or borrowing from other financial institutions. These include leasing companies, insurance companies, building societies, deposit taking institutions such as state owned co-operatives and the National Savings and Credit bank (NSCB), and development finance institutions, principally the Development Bank of Zambia (DBZ). Other finance institutions include those giving trade finance and finance management. Many of these institutions, especially DBZ, have suffered major losses through non-performing loans, especially to borrowers in agriculture and political insiders, and have almost all closed down. Another aspect of financial sector reform in Zambia has been the introduction of a securities market. This is discussed later.

A report by Ndulo (2000) concludes that, although financial sector reform is necessary for Zambia, the existing fragility in the country's financial system is likely to cause instability in the sector unless certain measures are put in place to sterilise the impact of likely capital flows. These measures include strengthening the supervisory capacity of the monetary, improving monitoring of the money markets and sound management of the fiscal budget.

## THE IMPACT OF PRIVATISATION

The economic impact of privatisation can be evaluated in a number of ways:

**1. Fiscal impact.** An explicit goal of privatisation policy was to improve government finances from the proceeds of the sale of companies, and subsequently tax revenues from the expanded operations of the privatised firms (White-Campbell and Bhatia, 1998). According to Fundanga and Mwaba (1997), modest gains have been made. Total receipts from privatisation of around 25 million dollars in 1995, rising to 200 million dollars by the end of 1996. By January 31, 2000, privatisation had raised over 300 million dollars (Business Africa, 2000), one of the highest amounts raised from privatisation transactions in Africa.

Many studies, including ZPA reports, indicate that a large number of SOEs were consuming a lot of resources from the state in terms of investment requirements and budget support, while achieving a negative return for the government (Chisanga, 2002; Sanderson, 2002; ZPA, 2001; USAID, 1998; Fundanga and Mwaba, 1997). Zambia Airways and the state-owned bus company were costing the treasury 5 million dollars each in government budget support for operations each year (USAID, 1998). ZCCM was incurring a loss of between 1 and 2 million dollars per day as a result of its delayed privatisation. It is estimated that privatisation, including liquidation, has cut government subsidies to SOEs from 47.5 million dollars in 1993 to less than 2 million dollars in 1997 (USAID, 2000). Similarly, Fundanga and Mwaba (1997) reported that government revenues have been boosted by the elimination of subsidies, contributing to a reduction in the fiscal deficit to single digit levels in 1993 and cutting the primary deficit to close to zero in 1994. However, there is little information on these savings and how they have been used by the government.

Some studies anticipated that the government's fiscal position would improve even further with the successful privatisation of the mines (Posthumus, 2000). However, much of the recent literature suggests that, instead of benefiting from the privatisation of SOEs, the government has had to provide 'sweeteners' in the form of gross underpricing of enterprise assets, price supports, subsidies or tariff protection (Bayliss, 2002, 2001; Posthumus, 2000; SARPN, 1999). This partly explains President Mwanawasa's opposition to privatisation of the remaining SOEs (The Post, December 6, 2002). It is argued that this has diminished or prevented the financial and economic returns of privatisation from materialising. In the case of the ZCCM privatisation, not only did Anglo-American buy the mines at a greatly reduced price of 30 million dollars, but in a parallel deal, Anglo sold its existing shares in ZCCM to the government for 30 million dollars -- a straight swap leaving no surplus for the government (AC, Vol 42 No 14; Posthumus, 2000). Moreover, some of the money has been used to meet the operational costs of the ZPA, re-capitalise SOEs for privatisation, off-set their debts, or give terminal benefits to victims of bad privatisation, as in the case of RAMCOZ workers (Zambia Daily Mail, October 24, 2002).

Although the divestiture programme has raised over 300 million dollars, much of this money has not been properly accounted for (Chisanga, 2002; Craig, 2000). The proceeds of sales should go into the Privatisation Revenue Account (PRA) -- held and controlled by the Ministry of Finance. The government decides what to do with the money within the alternatives provided for under the Privatisation Act. Although ZPA has an internal audit unit, the PRA is audited by the Auditor General's Office. Some analysts claim that no monies from the sale of the non-core assets belonging to ZCCM by the Government/ZCCM negotiating team were remitted to the Privatisation Revenue

Account and there is no information on what was received, where it was paid or to whom (see Chisanga, 2002). A Parliamentary Select Committee is yet to compile a report ascertaining how the privatisation revenues were handled by government (Ibid.). Arguably little or nothing has been spent on services for the poor, as reflected in the decline in key social indicators since 1992.

2. **Investment and growth**. Although some figures can be accessed from UNCTAD reports, empirical data on FDI is not easily available in Zambia. Instead, pledged investment as recorded at the Zambia Investment Centre (ZIC) is used as a proxy for FDI (Kani, 2000). Foreign participation is often used as a measure of the success of privatisation programmes (Dinavo, 1995; Galal, 1994). It is generally taken as a yardstick for measuring the degree of confidence that the international investor community has in the business environment of the country concerned. The overall emerging picture is that the Zambian privatisation programme has attracted a cross section of investors from the United States, the United Kingdom, India, South Africa and Germany, including companies such as Tate & Lyle, Unilever, Anglo-American Corporation, Lonhro, Phelps Dodge, Clark Cotton and South African Brewries. The major foreign investors so far have come from the United Kingdom mainly the Commonwealth Development Corporation (CDC) (mostly through conversion of debt to equity and exercise of pre-emptive rights) and LONRHO, and South Africa mainly through Anglo American Corporation (Fundanga and Mwaba, 1997). The Zambian programme has not substantially benefited from participation by US companies, companies from other European countries, Asia, as well as South America. Participation by firms from the Nordic countries has been particularly low (Fundanga and Mwaba, 1997).

Capacity utilisation in some privatised SOEs has risen from less than 41.8% before to over 58.2% after privatisation (Mulenga, 2002). This is reflected in productivity improvement in some privatised companies. For example, the new owners of Zambia Breweries, South African Breweries, which later also bought Northern Breweries, have modernised its plants and introduced new product lines. Several newly privatised enterprises, including the former national cement, cotton and sugar companies, have sought to produce in Zambia for export (USAID, 2000). There has also been some greenfield investment, especially in the service sector. In the retail trade sector, for instance, the PEPCOR group of South Africa have acquired a number of former state shops in the major urban centres. The World Bank (1996) argues that the successful privatisation programme in the mid-1990s acted as a signal to investors.

However, these achievements have been overshadowed by lack of growth in the economy, decline in many economic sectors, a fall in exports and lack of improvement in the standard of living (Chiwele, 2000; Kalyalya and Muuka, 1994). Since the start of reforms in 1992 positive economic growth has only been registered in 1993 and 1996. In a submission to the UN Committee on Economic, Social and Cultural Rights evidence collected by Kenny (2000) shows an increase in poverty in Zambia. Absolute poverty has risen from 69% in 1992 to over 80% today. By international standards, 85% of the population lives on less than 1 dollar per day, while 98% live on less than 2 dollars per day. Not surprisingly, President Mwanawasa, in a letter to his finance minister, complains that Zambia remains one of the poorest countries in spite of privatising over 80% of the SOEs (The Post, December 6, 2002).

The recent pull-out of Anglo-American Corporation (AAC) from the consortium which bought Konkola Copper Mines (KCM) has thrown into confusion expected growth from the privatisation of ZCCM. KCM is the biggest copper mining company in Zambia and employs an estimated 20, 000 miners. Some privatised firms such as Dunlop, have relocated to neighbouring countries, citing low trading volumes and a high production cost structure in Zambia (Chisanga, 2002; EIU, 4th Quarter, 1997). On the one hand, foreign capital appears to have benefited from the liberalisation of the economy, while on the other, some foreign-owned firms have moved production to more protected countries. Many local analysts blame this on a very liberal economic environment (Zam News, 1998). Zambia is said to be one of the most liberal countries in Africa. While Zambia has liberalised rapidly, its neighbours have not. This appears to create an uneven playing field, encouraging MNCs to move

manufacturing plants from privatised SOEs to more protected countries. This is worth investigating to find out whether a more liberal environment in Zambia encouraged or discouraged investment.

**3. Market structure and competition.** There is some evidence that privatisation in Zambia has contributed to competition and improvement in the quality of goods and services at low cost to the maximisation of consumer satisfaction (Chisanga, 2002; O'Donnel, 2002; Fundanga and Mwaba, 1997; EIU, 4th Quarter, 1996). The transport, food and retail sectors are reported to have greatly improved. In the transport sector, for instance, buses are always available on time and go all over the country at economical prices. The sector now employs more people than it ever did. There is also a continuous flow of investment into the sector, as evidenced by the modern coaches on all major routes. More importantly, nearly the whole sector is owned and managed by Zambians.

However, the market structure in key sectors such as telecommunication still remains uncompetitive. A private sector assessment study by IRIS (1998) revealed that Zambia has one of the most costly and poorly managed telephone systems in the world. In an attempt to regulate competition, the government has established a number of regulatory bodies such as the energy regulation body, the Communications Authority and the Competition Commission. However, these bodies are yet to rationalise their operations.

**4. Capital market development.** Some progress has been made with regard to capital market development. Nine firms are presently listed on the Lusaka Stock Exchange (LuSE). However, capital market development has lagged behind privatisation and the amount of capital that could be raised through the sale of stocks and shares is very small (Craig, 2001). Zambians have no money to buy shares, domestic savings are low and portfolio flows from outside are equally low. As a result, there is no money to facilitate increased trading on the Lusaka Stock Exchange. Some analysts have questioned the relevance of stock markets in such a context.

**5. Social impact.** The privatisation process has had a major social impact in Zambia. However, as in the case of the economic impact, this should be separated from the broader effects of liberalisation on labour markets and income distribution (see below).

**6. Labour markets.** There has been a tendency to confuse the impact of SOE reform and broader economic liberalisation with the real effects of privatisation. Many Zambians believe that the privatisation programme has brought despair and misery. While no detailed studies exist on the impact of privatisation on labour markets in Zambia, there is a broad literature which claims that the impact of privatisation on job losses has been minimal (Hamasaka, 2002; Bennell, 1997; Fundanga and Mwaba, 1997):

- It is claimed that between 1992 and 2001, out of approximately 70,000 formal sector jobs lost in Zambia, only 7,034 occurred as a result of privatisation (Hamasaka, 2002; JCTC, 1999). Indeed, much of this literature claims that privatisation has actually helped to preserve and recreate jobs which could otherwise have been lost had the SOEs not been privatised (Chisanga, 2002; Chiwele, 2000; Kani, 2000; Fundanga and Mwaba, 1997).

- According to Fundanga and Mwaba, some job losses reflect the transitory costs of moving on to a more efficient system. They argue that these costs need to be weighed against the potential benefits of even larger employment opportunities from more efficient expanding private firms. A similar boost in job creation has been recorded in the agriculture sector, especially in the dairy cotton, tobacco and sugar industries (Hamasaka, 2002). It is claimed that the privatisation of SOEs in this sector has created thousands of jobs through the out-grower schemes. However, this varies according to industry.

Furthermore there is evidence to suggest that manufacturing sector employment declined sharply following the privatisation programme. For example, twenty companies surveyed by Mulenga (2002)

reported a more than 50% decrease in employment. This survey revealed that, overall, 5009 jobs were lost and only 156 new jobs created three years after privatisation. This does not include redundancies in those firms that closed down following privatisation. Most of those who lost jobs are struggling to earn a living in the informal sector. Similarly, in the case of mining, the mismanaged privatisation of RAMCOZ -- one of the biggest mines sold after privatisation -- has resulted in the loss of over 10,000 jobs, while the whole town of Luanshya (with over 150,000 inhabitants) has become a 'ghost' town (see Posthumus, 2000). Moreover, foreign investment is too low to compensate for job losses (see Kenny, 2000).

**7. Income distribution.** There is no detailed information on the emerging patterns of income distribution in the privatised firms in Zambia. Kani (2000) notes that income distribution in Zambia, and consequently wealth distribution, has been and continues to be highly unequal. In the absence of broad enterprise ownership, it is expected that privatisation may have increased significantly the inequality in income distribution. Loss of jobs in manufacturing and mining would deepen income inequality.

### Privatisation aftermath

Available evidence indicates that some former SOEs, especially management buy outs (MBOs), have collapsed after privatisation (Chisanga, 2002; ZPA, 2000; Fundanga and Mwaba, 1997). These include the National Drum and Can Company, General Pharmaceuticals, Kapiri Glass Factory, Eagle Travel, Crushed Stones, and Lusaka Engineering Company (LENCO). The ZPA (2000) and the private sector assessment study by IRIS (1998) attribute their collapse to a variety of reasons, mostly of a business nature, including problems that existed prior to their privatisation.

The anticipated broad ownership of former state owned enterprises has not materialised. Only a handful of Zambian business people, mostly what Chisanga refers to as 'political insiders', have benefited from the privatisation of SOEs, mainly small enterprises. The undercapitalisation, coupled with bureaucratic constraints to accessing the funds from the Privatisation Trust Fund (PTF) has denied many ordinary Zambians the chance to buy shares in companies floated on the Lusaka Stock Exchange. This raises questions about the efforts made in broadening ownership.

### Post-privatisation review mechanisms

The ZPA has a Post-Privatisation Monitoring Unit. This unit is supposed to monitor investment pledges enshrined in the sales agreement. In the event of failure to meet the investment pledges or breach of contract, ZPA is empowered under the Privatisation Act to repossess the privatised firm or prosecute the new owners. Although there is presently no comprehensive study on the privatisation programme in Zambia, a review of the post-privatisation decisions of some privatised companies suggests that the new owners have met their investment pledges. However, there are some weaknesses in the follow-on or regulatory mechanisms. In spite of the existence of the Post-Privatisation Monitoring Unit, some new owners of privatised firms have breached their sales agreements. Binani stripped the assets of RAMCOZ and has not been penalised. This suggests the need to strengthen the regulatory mechanism in the post-privatisation era, especially given the impending privatisation of large state monopolies in the electricity and telecommunication sectors. There are also problems arising from labour regulation in dealing with redundancies.

## LESSONS FROM THE ZAMBIAN EXPERIENCE

This assessment suggests that the overall level of privatisation under the MMD government in Zambia has been substantial. As a consequence, the face of the manufacturing sector has been completely

transformed from one dominated by the state to a private-sector driven one, with many socio-economic benefits. However, this transformation is subject to a dual interpretation in the literature. Several important lessons emerge from this interpretation:

- The process matters. In the early stages of the privatisation programme, Zambia quickly achieved 'best practice' which provided a model to other developing countries.
- A careful separation of the sphere of the market from the sphere of the state is critical. Any mishandling of this separation can result in opportunistic behaviour by politicians and senior state bureaucrats, as the latter phases of the privatisation process in Zambia demonstrate.
- Privatisation should be seen as part of broader Private Sector Development (PDS). This requires addressing existing barriers to the business creation and expansion processes.

While there have been improvements in the structures under which business operates in Zambia, there are significant policy-induced and structural barriers to the business creation and growth processes, including poor infrastructure (Mulenga, 2002; Chiwele, 2000; Kani, 2000; IRIS, 1998). This has not been helped by regional and global constraints. As previously noted Zambia has liberalised rapidly while its neighbours have not creating an uneven playing field, encouraging both MNCs and regional manufactures to move production to more protected countries. Zambia's membership in the Southern Africa Development Community (SADC), Common Market for Eastern and Southern Africa (COMESA) and the World Trade Organisation (WTO) has not yet helped resolve these issues, and its numerous bilateral trade agreements are in most cases outdated (IRIS, 1998). The transition to a private-based market economy has become much more difficult than initially thought. Much of the policy formulation and implementation of privatisation in Zambia has proceeded as if these factors were not material. The Zambian divestiture experience suggests that a successful privatisation programme requires the following:

- political support and credibility;
- a supportive institutional and policy environment;
- an autonomous, preferably single, privatisation agency;
- careful programme design and implementation;
- transparent transactions and appropriate sequencing;
- donor support is critical to success but donor conditionality should be structured in such a way as not to distort the market price of SOEs earmarked for privatisation, especially key strategic industries;
- privatisation through broad-based ownership strategies should be encouraged; and
- social sensitivity is important.

### ALTERNATIVE OPTIONS TO THE PRIVATISATION OF PUBLIC UTILITIES

There is strong and growing public opposition to the wholesale privatisation of the remaining parastatals in Zambia. Trade unions, NGOs, civil society organisations and certain sections of the press have expressed particularly strong opposition to the proposed privatisation of Zamtel, ZESCO and ZNCB. Recently, parliamentary deputies rejected the privatisation of ZNCB. Even the Republican President has signalled his opposition to the privatisation of these firms. The primary source of failure

in these firms is not seen as state involvement per se, but state mismanagement as reflected in political cronyism, nepotism, cash diversion and resource mismanagement. The Mwanawasa government claims to have addressed this concern. The opposition to privatisation suggests the need for alternatives to the current practice of privatisation in Zambia. As previously noted, privatisation in Zambia has largely involved the transfer of assets from the public sector to the private sector. That is, 'change of ownership'. Other forms of privatisation, such as leasing/concessions, contracting out, deregulation and the transfer of service provision from the public to the private sector, have not been used. The growing opposition to the complete change of ownership in the privatization of ZNCB, ZESCO, Zamtel and other remaining SOEs suggests the need to explore alternative policies. In these alternative policies, change in ownership is not the crucial issue. Ownership can remain in public hands but management and restructuring are important. These alternative approaches may be far better suited to meeting the needs of the poor and addressing public concerns, as discussed below.

## Telecommunications: Zamtel

In order to reduce the high cost of telecommunication and ameliorate access, privatisation of Zamtel is unavoidable. However, given the strategic importance of telecommunication and its importance in trade and commerce, the privatisation of this sector would proceed cautiously. The objective would be to induce technological development and increase competition in the sector and subsequently reduce the cost of telecommunication services and increase accessibility. The government might regard Zamtel as a strategic firm/industry, in which case complete transfer of ownership to the private sector may be a difficult option for government. One option may be to find a strategic partner for Zamtel. In addition, government will need to encourage other telecommunication service providers to enter the industry and compete with Zamtel and the two existing cell phone companies.

## Transport

The railway network in Zambia is at the centre of the international routes linking Zambia and several neighbouring countries. However, because of the poor state of the rail track, operating inefficiencies, and the increasing frequency of accidents, Zambia Railways' freight traffic declined from 4½ million tons to about 1½ million tons between 1990 and 1996 (IMF, 1999). The shift from trains to road traffic is estimated to cost the Zambian economy between US$100–150 million per year in increased road deterioration and fuel costs. A SIDA-financed management team has been installed to immediately improve the railways' performance, while a more permanent solution is being sought by tendering concessions with regard to the railway system, which will take place before end-1999. Other options include public sector reform and corporatisation.

## Financial Sector

As the Ndulo Report (2000) notes, given the key role that the financial services sector has to play in the economy, deregulation and liberalization of the sector is of extreme importance. This ought to lead to improved welfare and resource allocation, and to increased efficiency. Increased efficiency is important because of the growing global trend towards the use of modem technology in the financial sector. However, these benefits have to be weighed against the possible effects of deregulation on financial stability. Nonetheless, there is need to create an environment receptive to increased innovation and use of modern technology in the sector. But given the growing opposition to the sale of state-owned financial institutions, especially the Zambia National Commercial Bank, the management contracting approach may be considered for ZNCB and the National Savings and Credit Bank (NSCB). On the other hand, the Development Bank of Zambia (DBZ) requires restructuring and its mission re-orienting in line with the changing economic environment, although management contracting might be an important option.

## FURTHER RESEARCH

This assessment has revealed a number of gaps in the literature. It suggests the need to conduct a detailed and comprehensive assessment of the net economic and social benefits of privatisation and to identify the constraints and opportunities for maximising welfare gains from privatisation, including the distributional consequences of privatising utilities. There is need for a study on the relationship privatisation and broader private sector development (subsuming the following: financial sector reform; linkages between privatisation and small enterprise development; impacts of globalisation and regionalisation (bilateral trade agreement) on private sector development, and; establishment of an entrepreneurship policy for Zambia).

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# PRIVATISATION IN NIGERIA

## LEGISLATION AND OBJECTIVES

Until 1986, the military governments conducted strongly statist economic policies seeking to acquire and control the greater proportion of productive assets. Private investors were deemed junior partners in economic progress that would be led by the public sector. The indigenisation decrees of 1972 and 1977 reserved some economic activities to Nigerian nationals, while in all other businesses 40% or 60% -- public or private -- Nigerian equity participation was required. These decrees were modified in 1990 in favour of new foreign investors and entirely repealed in 1995.

**IMF programme.** In 1986, a structural adjustment programme was launched under IMF auspices. The programme explicitly rejected the military government's recommendation that socialism should be Nigeria's governing ideology. However, although a privatisation decree was promulgated in 1988, of 110 state-owned enterprises (SOEs) then scheduled for full or partial privatisation, few were dealt with. In 1992, the World Bank complained that the value of Nigerian privatisations relative to GDP was less than 1% of what had been achieved in Argentina, Malaysia and Mexico. Following repeal of the indigenisation law in 1995, the government divested from its majority shareholdings in the four big commercial banks.

The 1988 programme was abandoned altogether in 1995 following a temporary return to import licensing and other economic controls. Alternatives to privatisation were proposed, including:

- the 10-year leasing of SOEs to technical partners, award of management contracts, and creation of joint ventures; and
- allowing competition with the state monopolies in electric power and telecommunications.

In 1998, a new programme of 'guided privatisation' was announced. Core investors were to be sought to take 40% stakes in electric power, telecommunications, the oil refineries and other enterprises, with the government retaining 40% and the remaining 20% sold to Nigerian investors. None of these ideas bore fruit before 1999, when civilian rule was restored.

**Civilian rule.** In 1999, the outgoing military administration issued a Public Enterprises (Privatisation and Commercialisation) Decree which, with some amendment, became an Act of the elected National Assembly. The elected president, Olusegun Obasanjo, had been military head of state in 1976-79, the heyday of statism, and did not convert easily to privatisation. The new 1999 constitution included management and operation by the state of 'the major sectors of the economy' among the 'fundamental objectives' of policy, and this without prejudice to the state's right to operate or participate in other sectors.

However, state enterprises yielded little return to the state on the 100 billion dollars Obasanjo said had been invested in them. The inefficiency of their operations, the incompetence of their managers and their endemic corruption required constant subvention from government revenues while the service and goods provided to the public were deficient in quantity and poor in quality. Obasanjo claimed that Nigeria was burdened with 1000 parastatal bodies. This total presumably included enterprises owned in whole or part by state governments. Though many of them have been sold or liquidated, their disposal has never been part of the federal programme.

## Privatisation Method

The 1999 legislation listed 51 enterprises for full privatisation and 52 for partial privatisation. The latter included the larger and more important federal SOEs and the original intention was to sell at most 40% of the equity of each to a private core investor, for the government to retain at most 40%, and for 20% to be offered for sale to the public. In addition, several enterprises -- most notably the Nigerian National Petroleum Corporation (NNPC), and also the television authority, federal radio corporation and news agency -- were to be commercialised, that is to become financially self-supporting. Others, including the river basin authorities and the national parks, were to be partly commercialised, responsible for meeting their operating costs but not capital expenditures.

The legislation created a National Council of Privatisation (NCP) as a policy-making body. It also had powers to determine the terms of sales, to approve the appointments of advisers and consultants and to approve the legal and regulatory frameworks within which privatised enterprises would operate. A Bureau of Public Enterprises (BPE) was to provide the NCP secretariat. It would implement Council policy, advise on the appointment of advisers and consultants, and prepare for privatisation of those enterprises approved by the Council. The Vice-President, Atiku Abubakar, has chaired the NCP since its inauguration, and Nasir El-Rufai has served continuously as Director-General of the BPE.

The NCP has a formal structure of standing committees -- for reviewing privatisation proposals, monitoring policy issues, finance (of the BPE in particular), publicity, and marketing. Each is chaired by a minister or prominent businessman, and has a membership composed of 'stakeholders' including representatives of enterprise managers, professional bodies, academia, labour unions, the organised private sector and 'other interest groups'. In addition 'steering committees' are set up with respect to particular sectors or for ad hoc purposes. A corresponding formal structure for the BPE has not been made public. Although the Bureau is advisory to the Council and executor of decisions made in the Council, it has much the higher public profile and appears to be the driving force in the privatisation programme. Most of the active work in privatisation appears to be done by the Bureau's Director-General and a small number of his colleagues in consultation with advisers, of whom very many are listed on the Bureau's register of consultants. The Council's role then becomes confirmatory, unless important political interests are involved. The workings of the BPE and its relations in practice with the NCP could be a further (but difficult) subject for further investigation.

## Policy Objectives

The objectives of privatisation policy are stated by the BPE to be reduction of the dominance of the public sector in the economy, so as to allow the private sector to play 'its proper role as the leading engine of growth'. In spite of investment of some 100 billion dollars (at May 1999) in the public enterprises, they have 'woefully failed' to perform the functions and attain the objectives for which they were set up. The policy is to reduce these unproductive investments in the public sector and gradually to transfer to the private sector enterprises better operated therein. The policy will also assist Nigeria's reintegration into the global economy by providing a platform to attract foreign direct investment (FDI) 'in an open, fair and transparent manner'.

The BPE has published a list of 114 companies, fully or partially state-owned, that are intended for privatisation. This list may be incomplete, and the number would be increased if, as is intended, the National Electric Power Authority (NEPA) is unbundled before privatisation:

**1. First phase.** The first phase of the privatisation programme aimed to dispose of government shares in 16 enterprises whose shares were already quoted on the Nigerian Stock Exchange. Thirteen have since been listed by the NCP as successfully privatised. Their activities are in cement

manufacturing, banking and the marketing of oil products. Core investors were found to take management and technical responsibilities. Where the take up of the shares offered to the public fell short, the balance was offered to institutional investors, including, ironically, state governments. A number of privatisations became controversial:

- Sadiq Petroleum, a Nigerian business, acquired 80% of the shares in African Petroleum. This acquisition followed the withdrawal of the bidder BP Amoco and a parliamentary enquiry. In 2002, it was discovered that due diligence had failed to reveal very substantial bank indebtedness not reflected in African Petroleum's books of account.

- The Benue Cement Company was sold to Dangote Industries, a Hausa conglomerate with no experience in cement, in preference to Lafarge Cementia. The decision illustrated some of the ethnic tensions present in Nigeria. The Governor and Assembly of Benue state -- ethnically Tiv -- strenuously opposed this sale, taking their protest as far as the president. The Tiv were outraged that ownership of 'their' industry was to be transferred to the Hausa.

Sales under the first phase were reported to total 19 billion naira (172 million dollars), but it is not clear whether this amount was net of fees paid to advisers and consultants.

**2. Second phase.** The second phase of the privatisation programme began in July 2000 intended for completion by May 2001. It was concerned with SOEs that sold their output or services at prices that were largely market-determined. Originally 42 enterprises had been identified, but the NCP listed only 22. The BPE produced a different list, in which 27 enterprises were for full privatisation and ten for partial privatisation. The NCP's list included Nigeria Telecommunications (NITEL) and Nigeria Airways. They were absent from the BPE's list, in which hotels, sugar producers and oil services companies were prominent. El-Rufai said earlier this year that he hoped half the second-phase privatisations would be completed by the end of 2002, but this now appears unlikely. The second phase has effectively become merged in the third and final phase, for which the original completion target was the end of 2001.

One success in 2001 was the ship repairing business Nigerdock. A Global Energy/McDermott international consortium bought a 51% stake in an indigenous oil and gas company. The minister of transport had tried to prevent the sale, claiming that it must wait on a judicial enquiry into the management of Nigerdock, but was overruled by the President on the advice of the consultants. McDermott has subsequently withdrawn from the consortium.

Among other enterprises originally included in the second phase, some of the hotels appear farthest advanced toward privatisation. However, privatisation of the Nicon Hilton Hotel in Abuja has collapsed because of the failure of African Properties to pay on time the contract price for a 51% stake.

## Privatisation by Business Sector

The poor state of SOEs creates major challenges for any privatisation programme. Utilities, including telecommunications, electric power, petroleum products, the ports and air transport, have been of special concern:

**1. Manufacturing.** Most of the manufacturing SOEs are in serious financial difficulty or are no longer operating as going concerns, and in some an absence of accounts would raise severe problems in due diligence. The BPE has listed in this category the two fertiliser companies, the three paper mills, the six vehicle assembly plants, and the four sugar producers located in Nigeria (there are two others partly owned in Benin and Swaziland). For these the first question asked of advisers is what

can be salvaged. The five steel companies and the aluminium smelter company could be added to this category.

**2. Telecommunications.** Licences for GSM telecoms had been issued under the military government of former president General Sani Abacha but not used. The elected government cancelled them and instead auctioned three licences early in 2001. Two were awarded at a price of 285 million dollars to the South African-based Mobile Telecommunications Networks (MTN) and Econet (Zimbabwean, but ownership of its Nigerian operation is now almost entirely indigenous). A third successful bidder, a Nigerian firm, was disqualified in contentious circumstances. Another 285 million dollar licence was issued to NITEL, the publicly-owned sole provider of landline telecoms, with a view to enhancing its saleability. MTN and Econet rolled out their networks in August 2001 and NITEL a year later. The impact on communications has been dramatic. However, there is a complaint that prices are too high, interconnectivity among the networks poor, and coverage confined to the big cities.

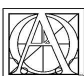
In NITEL itself, a 51% stake was offered for sale earlier this year. El-Rufai had once said it would fetch at least 2 billion dollars. In the event there was little interest with only three bidders. Investors International London (ILL) was preferred, having made a bid of 1.3 billion dollars. This was a Nigerian consortium which included three state governments as well as business interests, and whose name did not testify to any UK participation. It failed to produce the bid money on time, and the reserve bidder declined the offer to take its place. The BPE has since pursued the alternative strategy of seeking an internationally-reputable telecoms firm to operate NITEL under a management contract for 2-3 years, while preparing for an initial public offering of shares.

This year, bids were invited for a licence as second national carrier, to compete with NITEL in both fixed and mobile telecoms. Only two applications were received, both from indigenous consortia, and neither produced the required deposit by the closing date. In August, after the reserve price had been reduced from 285 to 200 million dollars, a provisional licence was awarded to Globalcom -- the second national telecoms carrier-- the largest shareholder of which is a Nigerian petrochemicals company. It looks to a Deutsche Telekom subsidiary for technical support. Globalcom, has signed a 10 billion dollar deal with the equipment supplier Alcatel, with finance provided by BNP Paribas. If Globalcom's plans are realised, it will overshadow the current capacity of NITEL within five years.

**3. Electric power.** The shortcomings of NEPA are notorious. About 70% of Nigerians lack access to electricity. Installed generating capacity is nearly 6,000 megawatts (MW), but actual generation is currently about 2,800 MW. The transmission network cannot carry more than 3,500 MW, local black-outs are frequent and he hydro dams at Kainiji and Jebba, which provide baseload energy, are described by the BPE as "a disaster waiting to happen". Some relief has been provided in recent years by independent power projects, installed by foreign firms in co-operation with state governments, but transmission has to be through the NPA. Large businesses generate their own electricity.

The BPE plans to unbundle NEPA to create six generating and eleven distribution companies, all of which would be privatised. Transmission, considered to be a natural monopoly, would be undertaken by a single company and remain in public ownership. However, this single company might be entrusted to a private concessionaire. An Electric Power Sector Reform Bill has been submitted to the National Assembly to provide, inter alia, for this unbundling and the creation of an independent industry regulator.

**4. Petroleum products.** Shortages of petrol, diesel and kerosene have been endemic. This is partly because their prices are subsidised. Also, local refining has run at not much more than one-half the installed capacity of 445,000 barrels per day, because of inadequate maintenance of the four state-owned refineries. Supplies of products are consequently supplemented by imports, which have often not been available in sufficient quantities to meet demand. Privately-owned refineries can now be licensed, but none is yet built.



The federal government owns the refineries through the NNPC, which is also the majority shareholder in the oil producing Joint Ventures, and has subsidiaries in petrochemicals, gas, and pipelines and product marketing. There is no proposal to sell the public stakes in Joint Ventures, but the refineries and the other subsidiary companies do appear on the privatisation schedules. In view of the dilapidated condition of the refineries, it is questionable not whether they ought to be privatised, but whether they can be. Nevertheless, following the two-day strike in September 2002 of unions in the oil industry -- intended to scotch the refinery privatisation plans by disrupting oil extractions and exports and the supply of products to the home market -- the privatisation of the refineries and other subsidiaries of the NNPC has been deferred. A committee has been set up under the chairmanship of the labour minister to examine and resolve the concerns of the workers and other stakeholders. The unions feared that jobs would be lost by privatisation of the refineries, and claimed also that product prices would rise. The latter claim is not entirely without substance, since the supply of crude by the NNPC to its refineries is at a price that -- although raised this year from 9.5 to 18 dollars per barrel -- is still below the current international price.

**5. The ports.** The seaports (other than oil terminals) are state-owned through the Nigerian Ports Authority (NPA), which has been fully commercialised since 1992. Ship-owners and importers have long complained of congestion at the Lagos ports, delay in unloading and clearing cargo, and high costs relative to other West African ports. Trade unions of the port workers are opposed to privatisation, and last July the minister of transport appeared to temporise, suggesting that investors be invited to develop the under-used ports beyond Lagos. However, the BPE has continued to work on plans for reform and privatisation of the ports in cooperation with consultants, and in September the unions took legal action in an attempt to check this work. They argue that the constitution forbids concentration of the means of production and exchange in few private hands, and that this would be the outcome of privatisation. They are expected also to petition the National Assembly. Privatisation would require amendment of the Act that set up the NPA.

5. **Nigeria Airways.** Deregulation of domestic routes in the 1990s allowed competition with Nigeria Airways, though the reputation of the privately-owned airlines is poor. Nigeria Airways remained the sole Nigerian provider of international flights, but lately has done so only nominally, the aircraft and flight crews being provided by South African Airways. In 1998, Nigeria agreed an ‘open skies’ policy with the United States, and subsequently auctioned its international air traffic rights. These decisions diminished the attraction of Nigeria Airways to possible investors and were one of the reasons why the International Finance Corporation last year withdrew as adviser for the airline’s privatisation. In addition, the National Assembly expressed opposition to the sale, the Ministry of Aviation disagreed with the BPE on its timing.

   Eventually, the proposed joint venture of Nigeria Airways and Airwing Aerospace of the UK was abandoned, as part of a deal whereby the National Assembly suspended its attempt to impeach Obasanjo. Unions in the aviation sector had condemned the joint venture on the grounds that Nigeria Airways’s outstanding severance and pension obligations must be satisfied before any sale is made.

## THE PROGRESS OF PRIVATISATION

Although privatisation has been on the federal government’s agenda for 15 years, little has been achieved. Not all the enterprises included in the first phase of privatisation have been sold. The second phase has made little headway, and its completion date has been repeatedly deferred. Actual privatisations have been few since the first stage of the 1999 programme: the five hotel companies are perhaps closest to disposal, but they cater mainly for politicians, other wealthy Nigerians and foreign business people

Most privatisations have been in banking, cement, and the marketing of petroleum products. These were activities in which private foreign interests were long established, and where privatisation often took the form of those interests buying back shares they had been obliged to sell under the indigenisation programme. The performance of the relevant enterprises before and after privatisation cannot be assessed with available information. However, a number of observations can be made about both periods:

- The profitability of banking has depended principally on the absence of a unified market in foreign exchange -- enabling foreign exchange bought at official prices to be resold at higher prices in unofficial or parallel markets -- and on the demand of public authorities for credit.

- Petroleum products have been sold at controlled prices, and, while these prices have often been exceeded, there is no evidence that privatisation has led to sales being made at less than the official prices. Majorities of the government's shares in two of the four privatised cement firms were sold to the UK company Blue Circle, which had retained interests in the Nigerian cement industry after indigenisation in the 1970s.

## Utility sell-off

The five major utilities -- NITEL, NEPA, NNPC, NPA and Nigeria Airways -- remain entirely in public hands:

- The improvement that has been made in telecommunication is due to deregulation and not to privatisation.

- Reform of the electric power sector has not got beyond the preparatory stages.

- Buyers may be hard to find for the oil refineries and petrochemical plants. Foreign investors may be more inclined to take up those activities anew.

- Privatisation of the ports is still the subject of consultation and attempts to remove the opposition of the various stakeholders.

- The opaque and possibly illegal deal struck for disposal of Nigeria Airways has just collapsed.

Most enterprises in the manufacturing sector are of doubtful saleability. Evidence is not forthcoming of any preparatory work on privatisation of NICON Insurance and Nigerian Reinsurance, the two newspaper groups, the railways corporation, the airports authority, the coal corporation, the mining corporation and iron-ore mining company. Indeed the majority of the SOEs listed by the BPE will remain unprivatised when the present administration terminates in March next year, and by when the programme of privatisation was intended to be entirely completed.

## Obstacles to Privatisation

There are a number of other obstacles to privatisation:

- **Government approach.** In August 2000, El-Rufai dismissed as unimportant attempts to value the assets of NITEL and NEPA, claiming that NITEL's 400,000 lines were of little value to a potential investor whose interest would be rather in the opportunities that ownership of NITEL would present. Similarly, the value of the assets of NEPA, which had not been maintained for 15 years, was 'minimal'. The value of NEPA was in the potential to

provide electricity to 70 million people who had never before received supplies. In short, Nigeria was selling opportunities, not assets. However, as was later shown by the GSM licensees, opportunities could be grasped without buying publicly-owned assets. If El-Rufai's doctrine were correct, private investors would be attracted by deregulation, considering much of the privatisation programme irrelevant. They had nothing to gain from buying enterprises recognised to be of little intrinsic value. This has perhaps been the principal obstacle to privatisation: it has been mistaken to be a necessary condition of deregulation.

- **Domestic politics.** Domestic political wrangling has further hindered the privatisation process. In April 2001, Obasanjo found it necessary to reiterate his government's commitment to privatisation. Ministers whose parastatal clients had been scheduled for privatisation were warned to desist from expressing contrary views. El-Rufai was told to bring disagreements with ministers or parastatal heads to the Presidency, rather than debating them in public. Evidently the administration was not united in a wish to dispose of the SOEs. Obasanjo himself was committed only because of the drain on federal resources resulting from the continuous need to cover their deficits. It would be unrealistic to expect a clean break from the statism that has been a leading element in the political culture of Nigeria over nearly all its lifetime. A residual distrust has remained of private enterprise, more particularly of foreign enterprise. The controversial plan to privatise the Nigerian Security Printing and Minting Company has recently been aborted, as part of a deal in which the National Assembly suspended its attempt to impeach President Obasanjo. To many Nigerians, including the chairman of the company, it seemed outrageous that 'the mint' should not be public property and that Nigerian currency should not be produced in Nigeria.

- **Ethnic rivalries.** The question likely to be raised in any privatisation is: who is benefiting? Little credence is given to the national interest. It is rather taken for granted that the matter has been arranged to serve the interest of some politically well-connected and wealthy individuals or some ethnic group.

- **Trade unions.** Trade unions resist privatisation for fear not only of loss of jobs but also because their members often are owed arrears of pay and have unfunded pension rights. In two of the proposed hotel privatisations the BPE has had to arrange clearing pay arrears. Pensions are a bigger problem. So far as they have been honoured, pensions have been paid from current earnings or government subventions. How they are to be provided under privatisation is uncertain. Although organised labour is unable to mount political pressure for long, it is strong and capable of inflicting serious damage through industrial action in some industries, above all in oil.

- **Indebted SOEs.** A committee on cross debt determination and resolution set up by the BPE reported in September that the total outstanding debt of the SOEs amounted to 1.28 trillion naira. Of this total, 77% was due to the federal government either directly or as a result of loan guarantees. Ten enterprises accounted for 85% of the total debt. They included the NNPC and its subsidiaries, NEPA, Nigeria Airways, NITEL and the Aluminium Smelting Company. Public enterprises were also owed 342 billion naira, 55% by the private sector, 8% by government and its agencies, and 36% by public enterprises. The ten big debtors accounted for 75% of the receivables. The committee proposed establishment of a debt clearing house in the BPE to remove part of the inter-SOE debt. Write-offs of debts owed to the government would substantially reduce the attraction of privatisation. Debts owed to, or by, the private sector might well prove difficult to clear. Finally, the African Petroleum case suggests that uncertainty about what the debt commitments actually are could be a serious deterrent to prospective purchasers of SOEs.

## Foreign Direct Investment

The privatisation programme has failed to draw in significant foreign direct investment. Foreign interests (banks, accountancy firms, stockbrokers, law firms) have been keen to participate as advisers and consultants, and a few have been willing to become technical consultants to Nigerian bidders for SOEs, but little foreign investment has been made. Poor infrastructural services, localised violence, endemic corruption, high business costs and political uncertainty make Nigeria an unattractive destination for foreign business capital. Exceptions are the oil and gas sector and businesses long-established in Nigeria such as Guinness, UAC and Blue Circle. Privatisations actually accomplished have relied heavily on Nigerian private businesses, incongruously allied in some cases with state governments.

Privatisation has not yet become a significant determinant of foreign investment in Nigeria. For the most part current investment -- by the oil majors, the GSM licensees, Guinness, UAC, British American Tobacco -- proceeds independently of the privatisation programme. Other potential investors are deterred by the high costs of doing business in Nigeria, the record of macroeconomic instability, and the uncertain political outlook. Business costs have benefited from the improvements in telecoms, but by the licensing of the GSM companies (and possibly in the future by the licensing of the second national carrier), not yet by the privatisation of NITEL, which remains problematic. Business costs in some areas may also have benefited from improvements in power supply, but through the establishment of independent power projects, not yet through the privatisation of NEPA, which also remains problematic. If supplies of petroleum products are not to remain heavily dependent on imports, they are more likely to come from newly established refineries than from privatised NNPC refineries. In short, privatisation has not yet become a salient factor in the development of productive capacity in Nigeria.

## CONCLUSION

The chief lessons to be drawn from the experience of privatisation so far are:

- expectations of how quickly it could be accomplished were wildly optimistic;
- enterprises with poorly maintained assets and uncertain financial obligations are unattractive to private investors;
- consequently expectations of the saleability of the parastatal sector were unrealistic; and
- deregulation has been more effective than privatisation in stimulating private investment.

## FURTHER RESEARCH

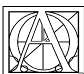
Several areas related to privatisation in Nigeria require further research. These include:

- The relationship between privatisation and income distribution or poverty;
- The effects of privatisation on federal receipts and outlays. At present data is only available on extremely broad fiscal categories;
- The regulatory process for privatised monopolies. This process is itself still being worked on.

## REFERENCES

There is a lack of readily available secondary literature on the privatisation process in Nigeria. An article by I.C. Okonkwo, 'The political economy of privatisation in Nigeria', in the *Journal Public Enterprise*, 11 (Dec 1991), 303-13, refers to the largely ineffective and superseded 1988 programme.

The websites of the BPE and the NCP, and the Nigerian and UK press, have been useful sources for this study. Locating other publications in journals and books that have been published in Nigeria and not much circulated outside the country could be an item for further work, though they would not necessarily be very helpful.



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