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The Distributional Impact of Privatization*

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Economists like privatization; the average citizen does not. Post-sale increases in firm profitability, higher returns to owners and investors, hikes in productivity and efficiency—these impress technicians. But the wider public is more struck by the apparent social costs. Privatization is seen as harming the poor, the disenfranchised and workers, raising prices for essential services, and giving away supposed national treasures to local elites, corrupt politicians, and foreign corporations and investors. For the general public, privatization is the prime cause of rapidly increasing inequality.

We take it as established that privatization has generally been good for efficiency and for new, private owners. What is known about its impact on the rest of society? At issue are the effects of privatization on the welfare of different income groups or households. This, in turn, depends on the prices groups and households face; their assets, including labor, human capital, land ownership and other physical or financial capital, and the return on these assets. We review the burgeoning literature and calculate that almost all privatization programs have done much more to enhance efficiency than equity. **At least initially, privatization has worsened wealth distribution and, to a lesser extent, income distribution**. The increase in inequality varies across countries, from slight (in Latin America) to very large (e.g., in Russia and other transition economies).

In detail: (i) Re **ownership,** troubling or disappointing outcomes are common. For example, privatization in many transition countries was accomplished by a mass and rapid transfer of asset ownership from society at large (in theory) to a small group of agile, daring, often unscrupulous actors. One can argue that these assets are finally and necessarily being put to productive use, and that negative distributional consequences are regrettable, perhaps unavoidable and, it is hoped, temporary——but there is no doubt that ownership has become more concentrated, and asset distribution less equitable.

The ownership issue also causes concern in OECD countries. Following privatization of the electricity sector in Britain, for example, the new private shareholders, at the expense of both government and the taxpayers, captured the overwhelming bulk of the financial rewards generated by the substantial efficiency gains. Both government and consumers/taxpayers did reap some gains; the contrast is not winners to losers, but rather huge winners to very small winners.

To address the ownership issue, transition governments distributed vouchers to exchange for shares. In many other countries shares in firms being privatized were offered to

employees, usually at a steep discount. Both tactics reduced citizen and employee resistance to privatization. In many cases sharp increases in share prices post-sale improved the income position of the shareholders, employee shareholders among them—but the number of people touched by such schemes is too small to make any difference to overall distribution patterns.

The distributional impact of vouchers has been particularly disappointing, not only in the infamous cases of Russia and the Czech Republic, but in Mongolia, Moldova, Kazakhstan, Lithuania and elsewhere. This is not in the sense of directly worsening the position of the recipients, who obtained the vouchers for free or at a nominal price, but rather in the sense of returns on the vouchers being so much less than anticipated or promised, and so much less than the amounts gained by the agile and/or dishonest few. Indeed, the principal distributional problem may be more psychological than financial: People were told, or it was implied, that the voucher was the means whereby the mass of state property would be equitably shared out among the citizens. This did not happen, and the disappointment and resentment engendered is still discernable and of political import in many transition countries, to privatization in particular, and to liberalizing reform in general.

Positive distributional outcomes in a few cases indicate that **privatization does not inevitably increase inequity.** For example, the Bolivian privatization program promoted both efficiency and equity, partly due to political foresight and clever program design, and partly to the stable macroeconomic situation prevailing when the program was launched, allowing authorities considerable financial latitude. (The public's perception of the program, nonetheless, remains negative.)

(ii) Employment: In the run-up to privatization, public enterprise employment numbers tend to drop, sometimes greatly. Reductions generally continue post-privatization. One survey of 308 privatized firms shows employment reductions in three-fourths of cases reviewed. Details are scant concerning the jobs people find after dismissal from public enterprises. It seems that those lucky enough to keep or get new formal sector jobs earn the same or more in terms of salary, but work longer hours, with reduced fringe benefits and security of tenure. Females, the less educated and especially those older than 45 find it harder to obtain new jobs. Assuming that those dismissed derive most of their income from employment, we conclude that, at least in the short-run, **the average employment effects of privatization have tended to worsen distribution** (though these effects tend to be overestimated in the public's perception).

(iii) Prices and access: Utility privatization generally results in network expansion and increased access to the service by the population, especially the urban poor (the rural poor are still generally left out). This is particularly the case in Latin America, e.g., in Peru, Argentina, Bolivia and Mexico. The increase in access is often substantial, and the rate of increase is far greater than before divestiture. Poorer segments of the population have benefited, disproportionately, from these coverage increases.

However**, increases in access are often accompanied by increases in prices.** The amount and structure of these price increases—partly due to the need for the privatized firms to raise their retail prices to cost-covering levels, and partly because inexperienced regulators have found it difficult to hold down or reduce tariffs in privatized infrastructure firms—are sometimes such as to produce, in the short-run, increased inequity. However, several recent studies in Latin America argue that the distributional benefits of increased coverage outweigh the negative impact of price increases.

Part of the price impact stems from the elimination of illegal connections to electricity and water networks. In Argentina, for example, 436,000 of the first 481,000 additional subscribers to the privatized electricity system were those who had had illegal hook-ups. In economic terms the shift from theft to paying status results in a clear welfare loss. On the assumption that a majority of those with illegal connections were lower-income people, the result is likely to be an increase in inequity.

(iv) Fiscal effects: On average, net fiscal effects of privatization are receipts on the order of 1 percent of GDP over the period of peak sale activity. That is a substantial amount in a single year, but modest relative to the size of economies or even of government budgets over several years. In some countries, the critical fiscal benefit of privatization has been to eliminate direct budget transfers (that subsidized commercially unviable enterprises, or compensated for politically determined under-pricing of an enterprise's service or products). That subsidy flow was substantial for politically visible public infrastructure services, such as energy utilities, railroads, and telecommunications; it caused rationing of under-priced services. This particularly affected poorer households, which often ended up without any services at all. The tax-financed subsidies provided benefits primarily to the non-poor in the form of employment at wages above the market, or under-pricing for those with access.

Many governments have used revenues from privatization to reduce the stock of public debt, a sensible application. But the distributional impact of privatization revenues is a function of the overall fiscal performance of a government, since even when revenues reduce debt stock, indiscipline on the fiscal side can lead to those revenues indirectly financing the government's current expenditures or increasing its space to borrow more. It is argued that privatization revenues in the mid-1990s merely prolonged the period during which Brazil tried to sustain the nominal value of its overvalued currency and put off the day of reckoning, which finally came in 1998. The potential fiscal benefits were thus lost as government used reserves to protect the currency. The same failing has been suggested in the case of Argentina. Revenues from privatizations in the mid-1990s were significant over a period of three or four years; despite those infusions the government failed to generate the fiscal surpluses it needed. Both the national and sub-national governments kept on borrowing, and ultimately the privatization revenues were swallowed up in the collapse of the currency and debt default in 2002—with severely negative distributional consequences.

(v) Conclusion: Privatization's distributional record is not nearly as bad as is popularly thought. But the process has often been poorly managed, particularly from the social perspective: Governments can and should do more in privatization to minimize the welfare costs of increases in inequality. They can do so without sacrificing efficiency

objectives; indeed, we argue, short-term attention to equity concerns can boost medium-term efficiency. Societies can benefit from information to guide the policies that help determine the outcome on both dimensions. Some might choose an initially less efficiency-oriented approach, if only to diminish long-run risks to efficiency and growth that initial resulting inequities would undermine (through corruption or rent-seeking for example). Similarly, it may be worthwhile to minimize the perception that privatization is unfair, so as to preserve the political possibility of deepening and extending reforms. What seems clear from the first decade of post-privatization experience is that one cannot dismiss concerns with equity outcomes as irrelevant, as simply the natural and temporary price to be paid for putting assets back to productive use. We believe it is desirable and possible to design and implement privatization to maximize its potential for gains in distribution as well as efficiency and growth.