Winners and Losers: Assessing the Distributional Impact of Privatization

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Summary. — Most technical assessments classify privatization as a success. But privatization, especially in transitional and developing economies, is seen as fundamentally unfair both in conception and execution, and it is widely and increasingly unpopular. We set out a simple framework for assessing the equity (or fairness) and efficiency gains from privatization, and for understanding any tradeoff between the two. We then review what is known about the distributional effects of privatization, focusing on changes in asset ownership, employment and returns to labor, access to and prices of utility/infrastructure services, and the selling government’s fiscal position. We conclude that many privatization programs have worsened the distribution of assets and income, at least in the short-run. This is more evident in transitional economies than in Latin America. It is less clear for utilities such as electricity and telecommunications—where privatization has resulted in greatly increased access for the poor—than for banks, oil companies and other natural resource producers, where the benefits have been concentrated.

1. INTRODUCTION

Technical analyses of the outcomes of privatization are generally positive. Privatization has increased profitability, returns to owners and investors, economic efficiency, and welfare and growth. But public perceptions of privatization are generally negative—and they are getting worse.

For example: a majority of people surveyed in 2001 in 17 countries of Latin America disagreed with the statement “The privatization of state companies has been beneficial...,” and the extent of disagreement was much greater than three years earlier. More than two thirds of 1,600 Russians interviewed in 2001 thought that they had lost more than gained from the privatization of state property; only 5% said the opposite. Of Sri Lankans polled in 2000, most thought that privatization had increased poverty and raised the cost of living, and over 60% opposed the privatization of the remaining state-owned firms. In Uruguay, a plebiscite revoked a privatization law narrowly passed by parliament; South African Nongovernment Organization (NGOs) and community activists have formed an Anti-Privatization League; in Mexico President Vincente Fox has been unable to make any progress on a promise to begin privatization of the energy sector; and in India parliamentary opposition halted (temporarily) the national privatization program in September of 2002.

Why this disconnect between technical assessments and popular opinion? The reason seems to be that technical studies focus only on shifts post-sale in operational and financial performance at the level of the firm, subjects about which the general public knows little and cares less. At the heart of popular criticism is a perception that privatization is fundamentally unfair in both concept and implementation: it is seen as harming the poor, the disenfranchised, the workers, and even the middle class; throwing people out of good jobs and into poor ones or unemployment; raising prices for essential services; giving away national treasures—and all this to the benefit of the local elite, agile or corrupt politicians, and foreign corporations and investors. The complaint is that, even if privatization contributes to improved efficiency and financial performance (some question this as well), it has a negative effect on the distribution of wealth, income and political power.

Key words — privatization, income distribution, wealth distribution, welfare analysis

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In this paper we review the burgeoning literature on the distributional effects of privatization. We examine which groups have gained or lost, and, where all have gained by some measure, which groups gained the most. Section 2 outlines a simple framework within which to consider the efficiency and equity gains and losses of privatization. Section 3 summarizes assessments of the overall financial, efficiency and macroeconomic effects, usually considered in terms of gains or losses in financial and operating performance at the level of the firm, returns to owners and investors, and latterly to aggregate welfare and to the competitiveness and growth prospects of an economy. Section 4 reviews what we know from theory and from existing studies on distributional issues, using the framework of Section 2. Section 5 concludes.

2. A GENERAL FRAMEWORK

Economists usually frame the question of equity or distribution in the context of a tradeoff with efficiency or growth. In a perfectly competitive economy at its production frontier, without any externalities, information asymmetries or other problems of missing or imperfect markets, there is likely to be such a tradeoff—as in Figure 1. On the frontier, the only efficient means of redistribution is through lump-sum transfers that have no effect on the incentives of economic agents, on prices, and so forth. A perfectly competitive economy can be highly inequitable (point A), or equitable (point B), often as a function of some initial allocation of the assets that generate income. A move along the frontier must lead to more efficiency and less equity or vice versa, the definition of a tradeoff.

In an economy that is not perfectly competitive, however, there is no such necessary tradeoff. At point C in Figure 1, the economy has the potential to move to both greater efficiency and equity, for example to point D. Most developing and transitional economies are less efficient than the economies of industrialized countries. Their low income is not only the result of their limited resources. They also often fail to use well what resources they possess, because of lack of enforceable property rights, policy deficiencies (e.g., distortionary tax systems, labor market rigidities), outright corruption, and the protected monopolies that state enterprises often represent. Historical injustices, civil conflict, political instability, crushing levels of disease or frequency of natural disasters may all also keep economies more or less permanently inside the efficiency frontier.

For any given productive capacity, many of these economies are also highly inequitable—because of government or policy failures that sustain insider privileges or corruption, or because of historically driven concentrations of wealth in land, oil, or other assets. Of course it is also possible for a society to be inefficient but equitable (“Cuba” in Figure 2) or highly efficient but also relatively inequitable (“United States” in Figure 2).

The point is that in most developing and transitional economies well inside the production frontier there is no necessary tradeoff between increasing efficiency and resulting...
economic growth on the one hand, and increasing equity on the other. This means it should be possible to implement privatization in ways that promote both equity and efficiency. To the extent that privatization reduces monopoly rents held by the wealthy, for example, it is likely to increase both efficiency and equity in the economy as a whole.\textsuperscript{5}

The structure and outcome of each privatization event is only one factor in the overall story of privatization’s effect on equity (or distribution) at the country level. Pre-privatization conditions matter—there will be more scope for an improvement in equity the more inequitable is the initial situation. Of course, the same is true with respect to initial inefficiency (Figure 3, paths a and b). The post-privatization environment (degree of competition, regulatory arrangements) can reinforce or alter the original path. Complicating matters, one-time privatization events, even if extended over several years, may help determine the post-privatization policy and institutional environment, and thus the long-term path of a society. To illustrate, mass privatization efforts in the post-communist transitional economies were justified on the grounds that privatization was necessary and perhaps even sufficient to create competition and induce increased firm (and overall economic) efficiency (Figure 4, from A to B via privatization, then to C in the post-privatization competitive environment). But the unanticipated outcome in several countries, most notably Russia, was that privatization initially increased the economy’s efficiency, but also locked in insider privileges (A to D); those insider privileges then brought competition-eroding corruption that undermined efficiency as well (D to E).\textsuperscript{6}

Because the post-privatization path of a society, in terms of wealth and income distribution, is neither unidirectional nor fully determined by transfer of ownership itself, any single snapshot-like assessment of where a society is relative to where it was before may be a poor indicator of the long-run effects of privatization. The outcome will be shaped by the amount of time since the process began, the extent to which the process directly affected the post-privatization environment, and by a host of independent factors that can affect the direction of the path (efficiency gain at point D in Figure 4 was only temporary).

We take it that the main or ultimate objective of privatization everywhere has been, or should be, to secure efficiency gains for the economy as a whole. Where distributional issues have been considered, they have generally been devised in the context of greasing the wheels to make privatization politically more palatable. Behind the usually paramount goal of improving efficiency has been the implicit assumption that government could and should use other, more traditional and direct instruments for redistribution, through tax and expenditure policies. Of course, that assumption has not always been borne out, because of political and economic constraints that are independent of privatization policy \textit{per se}.

Some stylized examples illustrate the logic of the framework (all cases are drawn from reality; see the sources noted in the text). With its planned economy, the former Soviet Union was, at the outset of transition, highly inefficient, though possibly reasonably equitable—with everyone comparably badly off (point A in Figure 5). Privatization in Russia made the economy both more efficient and at the same
time less equitable, as some former state assets were acquired by a relatively small group of insiders (path a). The resulting concentration further worsened equity, and stalled or even reversed efficiency gains, as many of the new inside owners concentrated on asset stripping rather than productivity-enhancing investments (path b). But, subsequent policy shifts, including a start on corruption control, seem to have halted the growth in inequity, by eliminating favors, and increasing efficiency. The elimination of some insider subsidies assisted in promoting a more competitive environment (path c).

In Peru, a state-run electricity utility was inefficient initially, with poor management, high technical losses, poor revenue collection, and irrational pricing. Its performance was highly inequitable, providing virtually no services to poor neighborhoods, while under pricing or failing to charge and collect fees in middle-class and rich neighborhoods or from large industrial users. (Point A in Figure 6.) Privatization increased efficiency dramatically, with offsetting effects on overall equity (path a). Offsetting equity effects appear to have resulted from a combination of higher prices for the previously insulated middle class with much better access (and a lower than “infinite” price) for the poor. Many poor, e.g., in rural areas, were still unserved and thus relatively worse off than other poor—though not worse off in any absolute sense. Other urban poor—those whose prior access through illegal hook-ups was eliminated, a common outcome of electricity privatization in Latin America and Asia—were made absolutely worse off. In subsequent years, equity gains could be reinforced or reversed depending on political pressures and on the competence and authority of regulators (paths b, c; see Tórero & Pascó-Font, 2001).

In the United Kingdom, privatization of the electricity sector provided large initial efficiency gains, but underestimation of these gains, combined with nonaggressive or incomplete regulation in the years immediately after sale, meant that the new owners, and not consumers, captured most of the initial gains (Figure 7, path a; see Newbery & Pollitt, 1997).

In Brazil, privatization of state telecommunications monopolies brought huge efficiency gains, with greatly increased coverage and quality for consumers and for productive sectors for which communications is a critical input. But underpricing of the firm to ensure the sale was successful may have meant that middle-income taxpayers lost out, and the windfall gains to a small number of new owners increased the overall concentration of assets (path a in Figure 8). If those windfall gains go
primarily to foreigners there may be no direct effect on the domestic distribution of wealth and income, but it still could produce a heightened sense of unfairness in the society as a whole. If the fiscal windfall is squandered (e.g., because it temporarily relieves the constraint on acquiring more debt), leading to subsequent increases in interest rates or reductions in social and other expenditures that are relatively progressive, these second-stage indirect effects may exacerbate the initial inequity (path b; see Macedo, 2000).

The overall point is that there can be no simple prediction about the distributional effects of privatization; the impact depends on at least three factors: initial conditions, the sale event, and the post-privatization political and economic environments. The privatization event may reinforce or undermine aspects of the environment that are conducive to equity, or may simply reflect that environment, or may be independent of it. Assessment of those effects will also depend on at what point on the “path” we measure the outcome. In the end, the question is an empirical one, unlikely to yield to any simple generalization across countries and over time. Thus, understanding the distributional impact of privatization requires an assessment of real cases, and the setting of those cases in the larger context of their political as well as economic environment and history.

At the same time, our framework suggests that in most settings there has been room for efficiency-enhancing privatization that is also equity enhancing. The conclusion is that where there has been a tradeoff it might have been avoided or diminished by a different process or by earlier or more vigorous attention to constructing a different post-privatization environment (regarding competition, regulation, etc.).

3. THE OVERALL ECONOMIC RECORD

As noted, the shift to private ownership usually improves a firm’s performance. Post-privatization, profitability has generally increased, often substantially, as have output, dividends and investment. After reviewing 65 empirical studies at the firm level, touching a wide range of sectors and across countries in different regions and of different income levels, Megginson and Netter (2001) conclude flatly that “…privately-owned firms are more efficient and more profitable than otherwise-comparable state-owned firms” (p. 380). 10

Privatization’s economy-wide effects on the government budget, and on growth, employment and investment are less established. An IMF review of 18 privatizing countries reports substantial gross receipts from privatization, accounting for nearly 2% of annual GDP (Davis, Ossowski, Richardson, & Barnett, 2000). Governments have generally ended up with about half that amount, reflecting the high costs of financial clean-ups, labor downsizing and sales assistance. Even 1% of GDP is substantial, but the long-run effects on government revenue generally come not from sales proceeds (a one time infusion) but from the elimination of subsidies to state enterprises, and from subsequent increased tax revenues from more profitable and productive private enterprises. Governments as diverse as Mexico, Côte d’Ivoire and Mozambique received, in the first few years following sales, more from privatized firms in taxes than from direct proceeds of sales. A “flow of funds” analysis in Bolivia shows, in the first four years following sales, a positive financial return to government of US$ 429 million—and this in a case where government received not a penny of the sales proceeds. 11 The IMF concludes that markets and investors regard privatization as a healthy signal of the political likelihood that government will stick with its overall reform program, implying somewhat higher investment rates in the economy overall.

Privatization does not always work well. In low-income countries privatization has proven more difficult to launch, and less likely to generate quick, positive effects. There are settings where many privatizations have not, or not yet,
yielded visible, positive performance improvements—in Armenia, Moldova and Guinea, for example. Even in countries where the process is an overall success, not every privatization improves firm performance. In three comparable studies, looking at 204 privatizations in 41 countries, between one-fifth to one-third of privatized firms registered very slight to no performance improvements, or, in some cases, worsening situations (Megginson & Netter, 2001, pp. 355–356). A two thirds to four fifths success rate is not bad. Still, inherited conditions place some firms beyond hope of internal reform, or some new owners operate in such poor markets and policy frameworks that a change of ownership is not by itself enough to turn the tide.

Because of this, controversy continues about the effects of privatization, in particular in settings where complementary reforms are not in place, competition is still limited, and regulatory and supervisory capacity embryonic. These institutional-administrative conditions are especially relevant in natural monopolies and in such sectors as banking. Nonetheless, the technical assessments generally show that privatization has been among the more successful of the liberalizing reforms from the point of view of increasing the efficiency of economies and thus their competitiveness and growth prospects. In more cases than not privatization has yielded good returns to new private owners, freed the state from what was often a heavy administrative and unproductive financial burden, provided governments in place with both a one-time and longer-term fiscal boost, and helped sustain a larger process of market-enhancing economic reforms.

4. DISTRIBUTIONAL EFFECTS

(a) What might happen?

So, privatization is generally good for the new owners. What about the rest of society? At issue in distribution terms are the effects of privatization on the welfare of different initial income groups or households. Their consumption depends on their income and the prices they face. Their income, in turn, depends on their assets, including their labor, human capital, ownership of land and other physical or financial capital, and the return on these assets. We list below the areas where one might encounter distributional shifts as a result of ownership change.

(i) Distribution of assets

Privatization shifts an asset owned (in theory) by the taxpayers as a whole to one owned by private persons or firms. Whether the shift in ownership reduces or increases overall equity in a society depends in part on the extent to which the price received by the selling state adequately reflects the underlying value of the asset. If the seller underprices an asset, for example, to ensure a quick sale or reward a political crony, equity will decline, in the short-run at least. The effect of the change in ownership on the long-run distribution of incomes between taxpayers and new owners ultimately depends on both the initial price and the post-sale stream of value the asset produces.

Privatization might be arranged to spread direct (i.e., share) ownership widely among the affected population. Privatization may also confer, or permanently deny, hitherto unrealized pension benefits, creating or eliminating an asset of employees.

(ii) Return on assets—labor

Privatization can change the return on assets, such as labor, in a manner that affects the distribution of income. For example, low-income workers might be more likely to be laid off than high-income workers, or dismissed low-income workers might have a more difficult time finding alternative employment, or the employment they do obtain might be less remunerative than either the work they left, or the work generally obtained by higher-skilled, higher-income workers who were also dismissed. Conversely, if privatization is an important element in an overall reform program that leads to higher growth and general job expansion, then previously unemployed or poorly paid workers might gain jobs, or better jobs.

The frequent allegation of union leaders is that cost-cutting measures by new private owners fall disproportionately and unfairly on workers. Labor leaders argue that it has been poor management and poor government policies that are the root causes of the financially troubled state of public firms, but it is labor that is asked to pay the price of reform. Proponents of privatization suggest that poor past performance in public firms requires a period of restructuring resulting in cuts in employment, part of which might occur before the actual sale. But the job reduction phase might, and it
is hoped, would be temporary. Under more dynamic private ownership total employment numbers might eventually recover, and even surpass, the number originally employed.

(iii) Return on assets—physical capital

Privatization can also change the return on the physical capital that is shifted. If the new private ownership is more efficient than the state, the return on the pre-existing capital (profits) will rise. This can constitute a perfectly legitimate reward to new effort or entrepreneurial skill, with spillover benefits (e.g., new jobs at higher wages) from the owners of capital to the economy overall. Conversely, if the new owners further neglect or strip the assets, value can be subtracted, and equity could easily suffer, as firms scale back or close and more jobs are lost.

(iv) Prices and access

Privatization can affect prices differentially across income groups. On the one hand, prices could fall. If increased competition is part of or accompanies the change of ownership, the private owner might be forced to offer lower prices. If private management is more efficient, some of the savings might be passed on to consumers. Conversely, prices—particularly in privatized infrastructure firms—might have to increase if they had previously been held below cost-covering levels by government action, or if new private owners move to end illegal connections to services and collect from previously tolerated delinquent customers, or if bodies regulating privatized infrastructure firms are weak or ineffective, etc. The distributional impact of price shifts will depend on the extent to which consumption of the goods and services in question varies by income group, and if different levels of consumption, or categories of consumers, face different prices.

Privatization might improve access to products by means of business expansion (that the investment-constrained public firm could not carry out). Conversely, the private owner might withdraw from or ignore some markets that the public enterprise was obliged to service.

Pricing and access issues are closely entwined. The prices citizens and consumers face can be broadly conceived to include whether or not they have access at all to a good or service (the price is infinite if they have no access to electric power, for example), and to take into account the quality of a good or service obtained (a lower quality for a given nominal price implies a higher real price). Steep price increases following privatization have been common (but not universal) in divested network or infrastructure industries, e.g., electricity and water and sewerage, less common in telecommunications. Very large increases in quality of service are typical.

On the equity side, the argument of reformers is that trying to protect the consumer by keeping the price of essential services artificially low did not work. It resulted in subsidies to the comparatively wealthy, and imposed costs elsewhere in the economy that outweighed the policy’s benefits. Better, it was thought, to let the firms operate under private, profit-maximizing ownership, and use other state mechanisms (taxes, regulation) to protect consumer welfare and acceptable levels of income distribution.

One can, however, readily think of situations where rational policies followed by private, profit-maximizing ownership might impose particular and disproportionate costs on the lower-income groups in a society. Again, infrastructure yields the most obvious examples. It is plausible that price increases in electricity and water—required to cover variable costs and expand the network—will fall more heavily on poorer consumers, who might be spending a higher percentage of their income on these services than do the wealthy. The often vigorous and aggressive moves by new private owners to collect arrears, and end illegal water and electricity connections, likely fall most heavily on the poor, especially the moves to end illegal connections. Even when a privatized service expands through investment into formerly unserved, and thus probably poorer neighborhoods, the residents might not be able to take advantage of it due to the high costs of connection fees or new equipment that the consumer often must provide to tap the water or power.

In telecommunications, a common result of reform and privatization has been “tariff rebalancing,” leading to large price increases in formerly subsidized local “fixed line” telephony, while introducing competition—usually producing rapidly falling prices—in international services and through mobile phone systems. But since the poor might tend to place most of their calls locally through fixed lines, the price increase could have a negative distributional consequence.

Issues of access (or coverage) arise in the context of infrastructure privatization. Due to
lack of incentives to perform, low tariffs and other investment constraints, many publicly owned infrastructure firms persistently failed to meet demand. With a relaxation of the investment constraint and a proper incentive structure in place, new private owners might see the logic of expanding to meet pent-up demand. Moreover, it is commonplace for sales contracts in infrastructure to specify investment and expansion targets, in order to extend the service to clients and regions formerly not served. In many instances, a disproportionate percentage of the new customers will be drawn from the lower income groups. The distributional impact of this expansion will be a function of the initial income of the new customers, and the relative shifts in expenditure that result from connection to the network. For example, where the poor were paying vendors for water, connection to the network could result in much lower unit costs—if they can afford the often substantial up-front connection fee. They might, however, face some minimal consumption threshold that exceeds the amount they previously consumed, raises their costs, and worsens distribution.

(v) Fiscal effects

Privatization may affect real income net of taxes if its fiscal effects are to reduce the tax burden differentially across households, or to increase the benefits differentially of government services such as education and health that are funded by new tax flows. The fiscal effects of privatization on income distribution—which come through any changes in revenues (including via affects on service expansion), and in expenditures, are indirect and possibly offsetting. Reduced hemorrhage of tax revenues and any increases in public expenditures probably benefit the relatively poor. But the indirect effects are easily offset in countries where broader fiscal problems eat up initial sales revenue and invite a prolongation of weak fiscal policy—ultimately with costs to growth as well as improved equity.

(b) What does happen?

A great deal of empirical work on these questions has emerged, all of it after 1990, and most of it in the last few years. After reviewing this evidence, we conclude that many if not most privatization programs list as an objective maintaining or improving distributional equity, and many have built in some specific measures (e.g., vouchers) to achieve this aim. But almost all privatization programs have done much more to enhance efficiency than equity. At least initially, and on average, privatization has worsened wealth distribution and, to a lesser extent, income distribution. The increase in inequality has varied across countries, from slight increases (e.g., in Latin America) to very large ones (e.g., in Russia and some other transition economies). Overall, in the terms of our analytical framework, the average privatization program reviewed in the literature has taken path x (Figure 9).

To disaggregate the general conclusion:

(i) Ownership

Troubling or disappointing outcomes are particularly common in regard to ownership. For example, privatization programs and techniques in many transition countries resulted in a mass and rapid transfer of asset ownership from society at large to a small group of agile, daring, often unscrupulous actors. One can argue, as do Anders Aslund and Andrei Shleifer, that despite the admittedly unfair and often illegal manner of the asset allocation, these owners have now put poorly used assets to productive work, the results obtained are superior to the alternative of leaving the firms in state hands, and the resulting distributional loss is an unavoidable, bearable price that must be paid for the efficiency gains, and indeed, for the transition to succeed. Others vigorously dispute this conclusion. While few would defend the notion that state- or socially-owned enterprises were managed mainly with the public interest in mind, there can be little doubt
that ownership has become more concentrated, with negative, if perhaps short-term, consequences on asset distribution.

The ownership issue has caused concern in less dramatic (and more empirically determinable) circumstances: in their study of the privatization of the electricity sector in the United Kingdom, for example, Newbery and Pollitt (1997) show that in the first years following sale, the overwhelming bulk of the financial rewards generated by the substantial efficiency gains was captured by the new private shareholders, at the expense of both government and the taxpayers. In this case both government and consumers/taxpayers did reap some gains. The contrast is not winners to losers, but rather huge winners to very small winners. In a subsequent study Newbery (2001) concluded that as time passed and electricity regulators gained experience, they became increasingly able to transform the efficiency gains into lower prices for consumers. As noted above, how one assesses privatization outcomes depends partly on when one makes the assessment. Nonetheless, the initial wealth distributional impact was negative in both the Russian and the British (electricity) cases (path a in Figures 5 and 7).

Mechanisms employed ex ante to address the ownership issue included offering vouchers to the general population, and reserving a tranche of shares in privatized firms for the employees (and sometimes retirees), usually at a steep discount. Both measures proved useful in reducing employee resistance to privatization. In many cases sharp increases in share prices post-sale have improved the income position of the shareholders, the employee shareholders among them, though the number of people touched by such schemes is, normally, too small to make any difference to overall distribution patterns.

In transition economies vouchers were widely disseminated, but the distributional impact has been 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. In some cases the best companies were not privatized by vouchers, but rather went, in nontransparent deals, to managers and their supporters. In other instances dispersed minority shareholders (shares obtained by vouchers) found that all assets were “tunneled” out of their firm, which suddenly consisted of nothing but liabilities; or the value of minority shares overnight fell to zero (as someone gained a majority stake and had no use for more shares); or the company was inexplicably delisted from the stock exchange, or the privatization fund invested in transformed without notice, discussion or appeal to an un-sellable status, etc. (Nellis, 1999, 2002). Overall, 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 by this failure is still discernable and of political import in many transition countries, to privatization in particular, and to liberalizing reform in general.

At the same time, generally positive distributional outcomes viewed in a few cases suggest that negative paths are not an automatic or inevitable result of the application of privatization. For example, the Bolivian program promoted both efficiency and equity (roughly from C to D in Figure 1) partly because of political foresight and clever program design, and partly because the prevailing stable macro-economic situation—in good part, a function of wise leadership—allowed authorities considerable financial latitude. (The public’s perception of the program, nonetheless, remains negative.) The point, for the moment, is not the extent to or the frequency with which equity-enhancing outcomes occur; it is that they occur at all.

(ii) Employment

In terms of returns on assets (other than shares of firms), the main topic of analysis has been the effect of privatization on employment levels and returns to labor. Despite the saliency of the employment issue, the matter has only recently received rigorous attention. It is clear that public enterprises were overstaffed, often severely so; that in preparing for (or as a substitute for) privatization, public enterprise employment numbers declined, sometimes greatly, and that these declines generally continued post-privatization. One survey of 308 privatized firms shows post-sale reductions in 78.4% of cases, with no change or job gains in only 21.6% (Chong & López-de-Silanes, 2002, p. 43).
The question of what kind of jobs people find after dismissal from public enterprises is just beginning to receive attention; fragmentary evidence suggests a lengthening of hours worked, and reductions in fringe benefits and security of tenure.

Overall, the evidence indicates that more people have lost jobs than gained them through privatization. Assuming that those dismissed derive most of their income from employment, and in the absence of detailed or persuasive information about the incidence and size of severance payments, or the amount of time required to find alternative employment, we conclude that: in the short-run, the average employment effects of privatization have tended to worsen distribution. These effects are probably overestimated in the public’s perception, given the capital intensity of State-owned enterprises (SOEs) and the relatively small percentage of national labor forces employed therein.

(iii) Prices and access

A widespread result of utility privatization is 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 seen in Peru (Tórero & Pasco-Font, 2001), Argentina (Chisari et al., 1999; Delfino & Casarin, 2001; Ennis & Pinto, 2002), Bolivia (Barja & Urquiola, 2001), Mexico (López-Calva & Rosellón, 2002), and in a number of other Latin American examples. The increase in access is very often substantial, the rate of increase is far greater than before divestiture, and the studies cited above (note that all are from Latin America) have concluded that the poorer segments of the population have benefited, disproportionately, from these increases.

Expansion is partly a function of profit-oriented owners moving to expand their markets—easier now that the firm can tap private investment capital—and partly a matter of sales contracts stipulating investment levels and network expansion targets. In cases where access increases significantly and prices do not rise greatly, increases in access have a positive distributional impact outweighing the negative effects of price shifts (McKenzie & Mookherjee, 2002, p. 55).

Often, however, increases in access are accompanied by substantial increases in prices. A number of studies reveal that the amount and structure of these price increases—partly due to the very common 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 such as to produce, in the short-run, increased inequity, e.g., in Peru, Spain (Arocena, 2001, and elsewhere). The finding is sufficiently generalized to prompt Estache, Foster, and Wodon (2002, p. 9), in their review of infrastructure privatization, to conclude: “One of the most painful lessons is that unless governments take specific actions, the gains from reform take longer to reach the real poor than the richer segments of the population, and hence worsen income distribution.”

An important part of the price impact stems from the elimination of illegal connections to electricity and water networks. Delfino and Casarin (2001, p. 23) note that in Argentina, for example, 436,000 of the first 481,000 additional subscribers to the privatized electricity system were those who had had illegal hookups. 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

Finally, we noted above that in studies covering 18 countries, mostly developing and transitional, the net fiscal effects of privatization were receipts on the order of 1% of GDP. 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 underpricing of an enterprise’s service or products). That subsidy flow had been substantial for politically visible public infrastructure services, such as energy utilities, water and sewerage services, railroads, and telecommunications, and often resulted in the rationing of underpriced services. In turn, that rationing had affected poorer households, which often ended up without any services at all. The tax-financed subsidies provided benefits primarily to the nonpoor in the form of employment at wages above the market, or underpricing for those with access.

Tax systems are regressive in many developing countries. They rely heavily on indirect
trade and value-added (consumption) taxes. To the extent privatization reduces the hemorrhage of funds to keep losing firms afloat, it produces indirect benefits, in terms of increased retained tax revenues. More efficiently managed, higher productivity private firms do tend to pay more taxes, thus increasing government revenues. All this could result in increased benefits to the relatively poor. That is, since expenditure patterns in most developing countries are somewhat more progressive than the income distribution itself (though hardly very progressive), this would also suggest an indirect benefit to the relatively poor. The critical question of whether or not this has happened has been neglected.

In many cases, governments have used revenues from privatization to reduce the stock of public debt. *Prima facie*, that makes sense. But the ultimate use 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 means those revenues are indirectly financing the government’s current expenditures or increasing its space to borrow more. Macedo (2000), argues 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. Mussa (2002) describes the same failing in 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 subnational governments kept on borrowing, and ultimately the privatization revenues were swallowed up in the collapse of the currency and debt default in 2002.

In Bolivia, the initial situation seemed better, because the government did not accept sales revenue but in effect retained one-half the value of the enterprises (as “shares” held to generate benefits for future pensioners) and exchanged the other half in return for the new owners’ commitment to invest equivalent amounts in the enterprises themselves. Even in Bolivia, however, subsequent fiscal problems led to the failure of the government (that succeeded the administration that had initiated the program) to pay out benefits to its older citizens to the extent originally undertaken.

5. OBSERVATIONS AND CONCLUSIONS

Our analysis is drawn from a limited number of countries and a limited set of sectors, over a relatively short period. Some important regions are more or less left out of the story; for example, very little is known about Africa. The Latin American studies reviewed treat almost exclusively infrastructure privatizations; little is known there or elsewhere about the distributional impact (possibly more favorable) of the larger number of privatizations of firms producing tradable and other goods in competitive markets—from large steel mills to small hotels. Our observations on the effects of privatization on asset ownership and wealth distribution depend heavily on findings from the transitional economies of the former Soviet Union and Eastern Europe, especially Russia and the Czech Republic. These findings arise from initial conditions that if not *sui generis* are thoroughly unlike those encountered in other regions and settings, or even in other countries in transition.

In transitional economies, the initial situation regarding economy-wide inefficiency (generally high) and income and wealth inequality (comparatively low) has not been systematically taken into account in assessing privatization’s impact on changes in inequality. We do know that in transition countries in the 1990s gross measures of income inequality—as measured by Gini coefficients; see Figure 10 in the appendix—increased from relatively equitable starting points, sometimes modestly (Czech Republic, Hungary, Slovenia), sometimes enormously (Russia, Tajikistan, Armenia). But what precise role did privatization play in the large increases in inequality? There does not appear to be much of an association between the sheer amount of privatization and the degree of increase; slow and fast privatizers are found at both ends of the spectrum. More likely explanations are the method of divestiture used, the type of new owner installed, the sequencing and intensity of other market reforms and, especially, the nature and density of the “institutional framework” prevailing in the country prior to, during, and after the privatization events.

Another limiting factor is that privatization has been, for the most part, a phenomenon of the 1990s. Our understanding of the effects of ownership change is mainly based on analyses undertaken shortly after its implementation (and most of these during an economic boom).
Static snapshots, taken at most within three or four years after the privatization event, do not tell the whole of what can be a changing story. To illustrate, in the mid-1990s the Czech Republic’s early, rapid and massive privatization program was judged a great success. As more information became available, and problems of both performance and fairness surfaced, the consensus interpretation shifted in 1997–98 sharply towards the negative. In Poland, in contrast, observers were at first critical of the country’s hesitant approach to the privatization of large firms, but then switched to greater enthusiasm as Poland returned to growth and macroeconomic stability. Indeed, Poland’s overall good performance, in the absence of large-scale privatization (combined with comparatively poor performance in rapidly privatizing Russia and the Czech Republic), led some to question the importance of rapid and mass privatization—and others to emphasize that quick privatization in the wrong environment could have the wrong effects altogether. Now the pendulum has once again swung back; major and recent fiscal and economic problems are partially attributed to Poland’s failure to privatize a set of large loss-makers when it had the chance. There have been similar shifts in interpretation and judgment in Argentina, Bolivia, Russia and the United Kingdom.

Almost all these shifts in interpretation have been based on variations over time of financial and operating performance of privatized and state firms, not distributional consequences. But since, as we have shown, distributional outcomes often depend on privatization’s efficiency and productivity results, shifts in interpretation of the overall economic consequences of privatization imply shifts in the assessment of the distributional impact as well.

This points to a third question. Are observed changes over time in income distribution associated with privatization, or are they produced by other reforms and policies taking place contemporaneously? A few pioneering studies (Galal et al., 1994; Jones, Jammal, & Gokgur, 1998; Newbery & Pollitt, 1997; Pollitt & Domah, 2001) construct a “counterfactual” that tries to assign to ownership change only those performance shifts post-privatization that are clearly caused by the ownership change per se. This means that the studies must state what would have been the performance had the firm not been privatized. These studies also attempt to determine the winners and losers from the privatization event, yielding a wealth of insights. But, as all these authors readily admit, counterfactual construction is based on an element of “crystal ball gazing.” As with other studies cited which employ partial and simpler devices to gauge who wins and who loses from privatization, the problem of attribution of the outcome—whether to ownership change or to something else—cannot be completely solved.

The fact is that the other reforms that accompany privatization do matter, especially for the distributional impact. Initial conditions, competition enhancement and market structure reform affect performance of privatized firms as much or more than ownership change. More than ownership change is required for the majority of households, poor and middle-income people to benefit from privatization’s efficiency gains.

In the case of infrastructure, where so much of the distributional problem has arisen, the key factor emerging from the above discussion is the creation or reinforcement of an independent, accountable regulatory regime, not simply in law, but in functioning practice—i.e., one that can design and monitor contracts, offer economically rational, legally enforceable rulings, and is resistant to capture by private providers. The better the regulatory regime, the better has been the distributional outcome from privatization of electric power, telephones, water and sanitation. A practical upshot for the case of infrastructure privatization is that selling governments, and those that assist them, should invest more upfront attention and effort in the creation and strengthening of regulatory capacity, and less in organizing quickly transactions. This means taking the time to lay the required institutional foundations. In the United Kingdom it took five years for the regulators of the privatized electricity industry to master the skills needed to squeeze out benefits for the average consumer (Newbery, 2001). If that is the case in an OECD setting, what can one reasonably expect from new regulators in developing and transition countries?

Advice to move slowly is not a costless prescription. The period between the launching of a regulatory regime and the assessment that it is in proper working order could be, probably will be, long. In the interim, losses in the affected firms could continue and mount, opposition to reform harden, reformers grow weary. We nonetheless judge that the prescription holds. Effective regulation is a double winner: neces-
sary in the short-run to minimize troubling distributional outcomes, it is equally important to maximize efficiency.

We conclude with three points regarding future policy. First, privatization of firms producing goods and services sold in competitive markets has not posed a distributional problem, even in low-income countries (Nellis, 2003). This form of divestiture generally opens the way for small and medium businesses to thrive. All developing and transitional countries should move forward and conclude this sort of divestiture.

Second, privatization’s distributional record even in infrastructure is not as bad as popularly thought. Where attention has been given to creating the right regulatory framework, these transactions have led to increased access, especially for the poor.

Our third, admittedly less concrete point is that selling governments can and should do more in their privatization programs to maximize the potential distributional gains. We believe it is desirable and possible for governments—and those that assist them—to design and implement privatization to obtain gains in both distributional and efficiency/growth terms. It is folly to dismiss equity problems as an unavoidable, temporary price to be paid for putting assets back to productive use. Equity can be enhanced without harm to efficiency; indeed, short-term attention to equity concerns can boost medium-term efficiency. Societies might reasonably choose an initially less efficiency-oriented approach, in order to diminish long-run risks to efficiency and growth that initial resulting inequities would undermine (through corruption or rent-seeking for example). Minimizing the sometimes real unfairness produced by privatization, and—just as important—countering the misperception that privatization is always and inevitably unfair, is worthwhile, so as to preserve the political possibility of deepening and extending reforms. In the end, a democratic government cannot implement reform when masses of people are in the streets attacking that reform, and, of course, no government can enact reform if it is not in power.

NOTES


2. See Tandon (1995), who argues: “...there are, of course, many cases where privatization appears to have ‘resulted’ in efficiency improvement; in most of these cases, however, the privatization appears to have been contemporaneous with deregulation or other types of competition-enhancing measures” (pp. 229–230).

3. Birdsall, Ross, and Sabot (1995) argue that the lack of any tradeoff explains why the East Asian tigers, with relatively low inequality, grew rapidly in the 1960s through 1980s compared to Latin America, with its high inequality.

4. Thus, as Easterly (2001) notes, additional investment capital or additional foreign exchange provided by aid will not necessarily yield any additional product or growth.

5. See for the theoretical underpinnings of this view Aghion, Caroli, and Garcia-Penalosa (1999), and Benabou (1996); for some empirical refinements, see Barro (2001) and Birdsall et al. (1995).

6. As argued by Stiglitz (1999a, 1999b).


9. Governments often underprice to ensure that the sale will go forward. The principal purchasers thus get a bargain. But another reason for underpricing is to encourage local citizens to take part. A mechanism devised with at least some distributional purpose may, overall, add to inequity. Large share price increases in the first day or days following sale are common; Megginson and Netter (2001, p. 366) review five studies documenting “significant, often massive levels of under pricing” in China, the United Kingdom, Malaysia and Hungary and elsewhere.
10. Other literature surveys reaching similar positive conclusions (see Sheshinski & López-Calva, 1998; Shirley & Walsh, 2000). A review of the effects of ownership change in transition economies is found in Djankov and Murrell (2002).

11. The Bolivians “capitalized” a group of the largest state firms, by selling 50% of equity to strategic investors, who committed to investing the total sales price into the firms themselves (Barja & Urquiola, 2001).

12. In many countries many poor people are not connected to any of the infrastructure networks, making moot the issue of gains and losses relative to other income groups. Still, a surprisingly high percentage of the developing world’s population is connected to the electricity grid; a smaller fraction has formal water or telephone services (see Komives, Whittington, & Wu, 2001).

13. Aslund (2001, p. 21) argues that any attempt to avoid or delay privatization in transition economies would only have compounded the pain; indeed “...the higher the level of privatization that an ex-communist country has attained, the higher economic growth it has achieved.” Shleifer and Treisman (2000, p. 38) see the inequities of Russian privatization as “…troubling, but not exceptional... privatization in Russia worked considerably better than its politically feasible alternative: doing nothing.”


15. Employees often sell quickly shares acquired in this manner, but even then they tend to benefit since government sellers tend to greatly underprice the initial offerings.

16. According to the European Bank for Reconstruction and Development (1999), vouchers were the primary method of privatization in nine of 26 transition states, and a secondary method in an additional 11.

17. Technical reviews assess the outcomes of Bolivia’s programs as positive in both efficiency and equity terms (Barja & Urquiola, 2001), but the program remains deeply unpopular in Bolivia. Nonetheless, the architect of capitalization, Gonzalo Sánchez de Lozada, was returned to the presidency in the elections of 2002.

18. Galal, Jones, Tandon, and Vogelsang (1994) attempted to estimate these factors for the 12 privatizations they studied. They concluded that no worker lost out as a result of privatization, but that conclusion appeared to rest largely on several questionable assumptions; e.g., that workers who lost their jobs had received the average wage.

19. Behrman, Birdsell, and Szekely (2000) found in a large sample of reforming Latin American countries that privatization was not responsible for increasing wage differentials, and indeed, was probably a factor mitigating the increasing disparities. Chisari et al. (1999) argued that privatization in Argentina was not responsible for the large increase in general unemployment seen in 1993–95. McKenzie and Mookherjee (2002) calculate that privatization was not a principal cause of rising unemployment in the 1990s in Argentina, Bolivia or Mexico.

20. This would seem to be easy to determine, but different studies reach different conclusions, depending on the base year chosen and several other factors. In the Argentine case, for example, Delfino and Casarin (2001) assert large price increases post-privatization; Ennis and Pinto (2002) state that prices for the privatized utility services declined significantly.

21. This study contains numerous practical suggestions on how to protect the poor, in terms of access and price, in infrastructure reform.

22. The few pioneering studies include Appiah-Kubi (2001), Due and Temu (2002), and Temu and Due (1998); see also Nellis (2003).

23. In these (see, for example, Barja & Urquiola, 2001; Delfino & Casarin, 2001; Ennis & Pinto, 2002; Estache et al., 2002; López-Calva & Rosellón, 2002; Tórero & Pasco-Font, 2001) innovative techniques are used to estimate the distributional impact of utility privatization using household expenditure survey data.

24. Djankov and Murrell (2000) argue that institutions particularly relevant to privatization are the functioning, accessibility and honesty of the legal/judiciary systems, particularly with regard to the arbitration of commercial disputes and the enforcement of contracts; the structure and prudential regulation of capital markets and insolvency/bankruptcy regimes; and the capacity of the state to regulate remaining natural monopoly firms to protect consumers from the abuse of monopoly power.

25. Not specifically in terms of shifts in distribution, but in terms of what change in total welfare was brought about by the privatization, and how was this welfare change, positive or negative, allocated among relevant societal actors or groups—the sellers, buyers, consum-
ers, workers, competitors, etc. This is similar to if not exactly the same thing as a calculation of distributional consequences.

26. See note 2 above, referring to Tandon (1995). See also Newbery and Pollitt (1997). In one of the only efforts to review econometrically the question, Zinnes, Eilat, and Sachs (2001) analyze the relative power of ownership versus nonownership reform factors in explaining privatization outcomes in transition economies. They conclude that both matter: In privatized firms “...economic performance gains... occur once key institutional and ‘agency’-related reforms have exceeded certain threshold levels” (Abstract). But, the same nonownership changes in the absence of privatization change produce much less effect.

REFERENCES


FURTHER READING


APPENDIX