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INTRODUCTION

Privatisation is one of the main events of the economic history of the last decades. The privatisation record to date is impressive, both in developed and developing economies. Despite the relevance of the process and the extensive research recently carried out, several aspects of privatisation such as its determinants, methods, and economic and social implications warrant a systematic analysis and research efforts. Given the relevance of privatisation policy in the European context and in the markets for the services of general interest (SGI), it is imperative to analyse the record of privatisation and understand the causes behind failures in order to improve the process in the future.

Privatisation is a landmark economic policy of the last two decades both in developed and developing nations. Yet some countries have pursued a consistent and sustained privatisation policy as a part of wider reform packages, while in others ambitious programmes have been blocked on their way by adverse interest groups, so that privatisation has been sporadic and small-scaled. Furthermore, some governments, have typically transferred the majority of capital of State-owned enterprises (SOE) to private investors, while in continental Europe the prevailing corporate governance model in privatised firms appears to be the separation of ownership and control, typified by government wielding power through pyramiding and statutory constraints especially in services of general interest (henceforth SGI). Finally, a cosmic "disconnect" is arising between the academic consensus and how privatisation is perceived by the population, especially in transition economies and in the poorer regions of the world. In these circumstances, it is imperative to analyse the true record of privatisation and understand the causes behind failures in order to improve the process in the future.

The gradual shift from State to private ownership of productive assets has been a distinguishing phenomenon occurring in the last two decades in several European countries, and the cornerstone policy of the transition to a market economy in virtually all new accession countries. A thorough investigation of why and how governments have privatised SGI, and to what extent privatisation yielded the desired outcomes in terms of competitiveness, economic growth and social progress

is key to design future privatisation processes and complementary policies, including liberalisation and regulation.

The research output of the project has tackled the different aspects in sequence, as we can detail in the following.

1 PRIVATISATION: POLITICAL INCENTIVES AND INSTITUTIONAL CONSTRAINTS

Possibly the strongest determinant of privatisation processes has been to raise Government revenue. Even if the demand for privatisation emerges from this source is privatisation, is it optimal to privatise "simply" to raise cash? The answer is clearly negative, as there are more neutral ways of raising cash, and our research stresses among other things that financial constraints leading to "forced" privatisation induce inefficient investment patterns. We also point to the relevance of distributional issues and political economy objectives, as some interest groups may favour privatisation even if not needed for other groups.

In this perspective, the Project's **first objective** was to study the political and institutional incentives and constraints affecting privatisation, **namely**:

- a foundation for the link between electoral rules (i.e. majority voting v. proportional systems), political orientation and privatisation activity;
- empirical tests of the theoretical results;
- studies of the political economy of privatisation and regulatory reform covering the evolution, the sectoral breakdown and the methods of privatisation processes also in Euro-Mediterranean Partnership countries.

1.1 How privatisation can be put at the centre of the debate

A first aspect the research has been to try and understand why the political and social support to privatization can rise and fall following cyclical patterns. These waves can actually be studied on the basis of a model of political competition where the issues are not given exogenously, but rather arise endogenously as parties give them political salience during the electoral campaign. Electoral winning policies may not be intermediate, moderate positions on which the parties would tend to converge. In contrast to the traditional Downsian model, a policy alternative to the status-quo can be initially presented as an innovative, even 'extreme' proposal by the challenger party in opposition, seeking to distance itself from the governmental status-quo. Eventually some policy consensus may be created in the voters'

concern, often around innovative alternatives, and when the social consensus about the best alternative to the status-quo is sufficient, it makes this policy position to cease to be the subject of controversy.

In our model, political parties or candidates do not compete to win an election only by `moving' their policy positions across the policy or ideology space, but rather by shaping the space with choices of issues, to which they try to give salience during the electoral campaign. Giving salience to an issue implies proposing an innovative policy proposal on the issue as an alternative to the status-quo policy, and turning it into "news" with some effort (investment) in order to make it relevant for the voters' electoral decisions.

The interest in this direction derives mainly from the ambiguous empirical validation found for some of the most classical results of traditional Downsian models of electoral competition. Systematic cross-country and long-term empirical observations do not give strong support to canonic results, namely that: (i) parties would converge in their positions in equilibrium (in single-dimensional spaces) and (ii) there would be "chaos" or at least permanently changing party positions in the space (in multidimensional spaces). In contrast, we rather observe that in well-established democracies political parties both converge on some issues and keep distant positions on some other issues. This does not exclude, however, relatively frequent alternations of parties in government. In our approach, this can be greatly explained by changes in the agenda of relevant issues for different elections.

We reach this conclusion by first taking some basic elements of traditional Downsian models, which can be summarized this way: party's policy positions are well defined; they are accurately estimated by voters; parties care only about winning, and in particular about winning the next election; candidates are part of a unified team; voters care only about the next election and about the party positions. We also assume that elections take place within a single constituency, between two parties, in a single round, by plurality rule (which is equivalent to simple majority for only two parties), and for a single office.

In contrast to traditional Downsian models, we assume that the policy space on which parties compete is not given, whether it is single-dimensional or multidimensional, but formed precisely as a consequence of competitive party's strategies. More specifically, the model assumes that political parties do not make

electoral decisions simultaneously, based on calculations about other parties' likely strategy, but electoral competition develops in a sequence. There is an incumbent party in government and a challenger party in the opposition. As is usually observed, the incumbent party can have an advantage in promoting issues and setting the agenda because it can present actual policies, that is, policies implemented from the government with concrete consequences on citizens' wellbeing, in contrast to dubious hypothetical results of policy proposals presented from the opposition. But an opposition party or candidate can innovate in the public agenda by politicizing new issues on which it can be able to present potentially winning proposals. The party which moves first, that is, the one giving salience to one issue on which the competition may focus, can have an advantage. Of course, party leaders choose to give salience to an issue because they may think their policy position on the issue will be capable of gaining the favor of the majority of the public. Each party expects a higher probability of victory if its chosen issue becomes salient in the voters' decision.

The issue space is, thus, highly multidimensional. But on each issue electoral competition is single-dimensional. While the agenda, namely the set of issues on which parties compete, changes from one election to another and even within an electoral campaign as a consequence of party's strategies, there is single-dimensional competition on each issue, once at a time and separately.

Our discussion centers on the criteria for party choices of issues and the subsequent campaign outcomes. A party will choose a priority issue to campaign for if it is a likely winning issue, that is, it has a likely winning position and it is likely to become decisive in the election. Whether an issue will become a winning issue depends on two variables: (i) the ex-ante, pre-campaign *salience* of the issue in voters' concerns and (ii) the voters' support or *consensus* in favor of a policy proposal on the issue.

Parties have to trade off the two variables. If one issue is highly salient in the voters' concerns, but the voters are highly divided about which of two possible policy proposals is better, choosing to campaign on the issue by holding one of the policy alternatives may be risky. Then the incumbent party in government may prefer to defend the status-quo on the issue, which may force the challenger party in opposition to choose another issue which may be less salient among voters. If,

on the contrary, there is broad social consensus about the best policy alternative to an unsatisfactory status-quo on one issue, but the issue is not a priority for voters' electoral decision, running on that issue can attract little attention.

We find that parties do not compete, in equilibrium, on issues with both low salience among voters and low consensus regarding the best policy alternative. However parties may choose not to campaign on those issues with highest salience in voters' concerns, thus postponing solutions to unpopular status-quo policies with considerable social discontent. Although parties can compete on issues with either high salience or broad consensus or both, the most likely winner candidate always campaigns on the issue with the highest salience and consensus, if it exists. We claim that successful privatization programs provided the salience and consensus necessary to make privatization an attractive issue to political parties in other countries and hence a politically viable policy.

1.2 Political orientation, fragmentation and privatization delays

A second relevant aspect is political fragmentation. Both theoretical literature and specific case studies suggest that such fragmentation, which is related to the number of agents with veto power in a given political system, hampers the implementation of policies with significant distributional consequences, such as privatization. A lower political fragmentation favors executive stability and allows incumbent governments to privatize a sizeable fraction of their SOE sector sooner, as the constituency of the "losers" from the policy change is less likely to enjoy bargaining power. On the contrary, highly fragmented political systems tend to disperse decision-making power among different actors, so that executives are weaker and characterized by higher turnover. In this context, the different political actors will hardly reach an agreement about how to distribute the burden of the policy change, and privatization will be delayed by a "war of attrition".

In particular, we are interested in the timing of sales, which varied greatly across countries. We argue that bargaining among political agents may delay the implementation of privatization reforms. Some governments have promptly entered the advanced stage of privatization reforms and raised a significant fraction of their revenues earlier, while others have lagged behind.

In this framework, privatization can be seen as a major adjustment policy with significant distributional consequences. First, privatization curbs political interference, improves managers' incentives, and tends on average to increase the efficiency of firms (Megginson and Netter (2001)). Second, privatization has important distributional effects as it typically involves a transfer of wealth from insiders of State-owned enterprises (such as employees) to outsiders, especially the new shareholders. Indeed, state sell-offs have been often associated with restructuring and layoffs, with efficiency gains accruing to shareholders of newly privatized firms. If a country's political system is highly fragmented, the interest group of "losers" from privatization has voice in the political arena and engages in a war of attrition which delays the efficient policy change. In this perspective, war of attrition models yield therefore the prediction that the expected delay in implementing privatization is increasing in the degree of political fragmentation .

Besides timing, notice that the extent of divestiture also varies greatly across countries. In some countries, governments have pursued a consistent and sustained privatization policy as a part of wider reform packages, while in others ambitious programs have been blocked on their way by adverse interest groups, so that privatization has been sporadic and small-scaled.

The United Kingdom provides an illustrative example of the first kind of privatization policy. Privatization continued apace with important sales in the newly liberalized electricity market and in the water industry. At the end of the third Conservative legislature, the annual proceeds approached £5bn and virtually all State-owned corporations have been sold out.

Importantly, the privatization process in the United Kingdom was initially fiercely opposed by the trade unions. In 1985-86, the National Union of Mineworkers went on a two-year strike against the restructuring of the to-be-privatized coal industry. The engineers of BT also called a strike to oppose the major reductions in the staff numbers that privatization foresaw. However, the comfortable majority enjoyed by the Conservatives in Parliament allowed to push back the opposition and to accomplish the announced program.

Some countries' privatization history is also fraught with failed attempts. The Belgian case is certainly interesting in that respect. A significant attempt to

restructure and denationalize the public sector was made at the beginning of the 80s under various weak coalitional governments led by Prime Minister Martens. This attempt was thwarted by trade unions in 1983, with a general strike lasting several weeks. This strong reaction forced the governments to postpone this first reforming effort, and something similar happened in 1986. Only at the beginning of the 90s, were the sales recommended by the 1986 public commission finally launched, amid strong political and social resistance leading to a new wave of strikes by public sector employees. However, the process was completed because of the need to meet the Maastricht convergence in 1995, when the prime Minister obtained by the Parliament a special authorization to legislate by decree on certain economic matters, including divestiture. Only under these exceptional rules, the Belgian government finally floated in the stock market a large number of shares of two important SOEs (i.e. Distrigaz and Dexia).

Therefore, one can see that different political institutions matter in explaining a country's ability to implement policies with significant distributional consequences, such as privatization. Particularly, political systems based on majority voting – as opposed to proportional systems – should be more likely to privatize. Majoritarian systems are characterized by a set of institutions which tend to reduce the number of veto players, which results in greater executive stability. On the contrary, consensual or proportional systems tend to disperse decision making power among different actors, so that executives are weaker and characterized by higher turnover. In a majoritarian country, the greater political cohesion of the parliamentary coalition supporting the executive allows incumbent governments to privatize a larger fraction of the SOE sector, as the constituency of the “losers” from the policy change is less likely to enjoy bargaining power. On the contrary, in proportional countries the different political actors will hardly reach an agreement about how to distribute the burden of the policy change.

We test this prediction using an original dataset with continuous and time varying measures of political institutions for 21 OECD economies. Our panel estimates show that indeed political institutions matter in privatization. Majoritarian countries, characterized by lower political fragmentation, tend to privatize more, even after controlling for other economic and political determinants.

A political economy approach seems therefore useful in understanding the determinants of privatization. This fact begs a natural question: does ideology or political orientation also matter? According to a largely held view, governments supported by right-wing coalitions are more prone to privatization than leftist governments, traditionally more inclined to broaden the size of government.

Another relevant aspect is the political orientation of the government and its re-election concern. According to a largely held view, governments supported by conservative coalitions are more prone to favor market economy, and therefore privatization, than leftist governments, traditionally more inclined to reduce social inequalities and to broaden the size of government. In the privatization history large scale processes implemented by right wing executives abound, France and United Kingdom providing two main examples. However, center-left governments have also embarked privatization, the Italian case being significant in this respect.

However, the idea that privatization policy is adopted on the grounds of ideological preferences is not completely satisfactory. Theoretically, political preferences should instead matter in the choice of privatization method. Even if governments of all political stripes may privatize, only market-oriented governments design privatization to spread share ownership and foster popular capitalism. The rationale for this policy is re-election: by selling underpriced shares in the domestic retail market, right wing governments make equity investment attractive for the median voter, and create a constituency interested in the maximization of the value of financial assets and averse to the redistribution policies of the left. Strategic privatization can therefore be a rational strategy for raising the probability of success of market-oriented coalitions at future elections (Biais and Perotti, 2002).

Extensive testing has been conducted over such hypothesis; see, for instance, Megginson et al., 2004. All these empirical studies consider the causality going from some measure of the ideology of the executive in charge, to the share of privatization revenues raised over the domestic retail market during the same period. Thus, what they test for is the existence of a political rationale for the method chosen to privatize, which appears to be a robust finding in the data. However, it should be clear that this is only part of the story. What is left to test is whether such strategic policy-making works or not, i.e. whether shaping

privatization to achieve some form of popular capitalism actually increases the chances of election by the conservative parties. The simplest way to detect the existence of such an effect is to look for causality going the other way round, i.e. from the share of privatization issues addressed to the domestic retail market over some period, to the electoral result in the following period.

This is definitely an empirical task, and along these lines we are thus interested in possible *feedback effects* from privatization to political equilibria. In particular, State Owned Enterprises (SOEs) sell-offs may foster financial markets' development and participation rates, thus eventually increasing support for market oriented governments. The hypothesis tested is therefore that the probability that the coalition winning the elections is conservative is increasing in the amount of privatization shares spread among domestic voters.

Our results indicate that - in advanced economies - the partisan orientation of the government has a significant impact on the timing, extent and methods of privatization. Governments leaning towards the right of the political spectrum privatize sooner and more. Importantly, they tend to sell shares in the domestic retail market rather than selling them to strategic investors or abroad, as theory suggests. This evidence confirms that privatization is politically motivated, and that a political economy approach is particularly useful in understanding why and how divestiture takes place around the world.

1.3 Case studies

These general (theoretical as well as empirical) analyses have been complemented by detailed case studies on the Middle East and North Africa (MENA) region. MENA countries have experimented privatization with varying degrees of success since the late 1980s. The United States played a pivotal role as the largest shareholder of the International Monetary Fund (IMF) and the World Bank by exercising a decisive influence upon the lending practices of these international finance institutions (IFIs). From the 1980s until the mid-2000s, these two institutions were instrumental in the diffusion of neo-liberal policies around the globe by often making their financial assistance conditional upon the adoption of market reforms, which included privatization as a top priority.

By the end of the 1980s, privatization promised a quick economic turn around, although it was hardly clear at the time what exactly it could deliver in the long run. Although the results were often quite positive, failures and controversies abounded depending upon the economic, political, and social factors within which state divestiture took place (World Bank, 2005). In Russia, and most of the former Soviet republics, privatization was marred by widespread crony capitalism and corruption. In Latin America economic efficiency gains were tangible, but in many countries of that region governments chose highly controversial privatization strategies, which lacked political legitimacy and eventually led to a popular backlash. In some instances, dissatisfaction with market reforms led to re-nationalization (i.e., Argentina, Bolivia, and Venezuela) of privatized assets and service functions.

Within this context, and despite abundant theoretical studies which prescribed a series of preliminary steps to promote competition and strong regulatory institutions prior to privatization, international financial institutions, in their assistance to reforming countries put a premium on speed rather than on transparency and the establishment of adequate macro and microeconomic institutions (Stiglitz, 2002). Moreover, from a technical standpoint, "no distinction was drawn between regulated industries and competitive ones, although a few countries enacted but could not properly enforce antimonopoly laws" (World Bank, 2005). The underlying assumption of this approach was that while speed could create initial economic distortions, eventually the market would correct itself and eliminate the less efficient firms or shareholders. However, placing a high priority on speed only exacerbated the controversial nature of privatization, thus inducing governments (with the blessing of IFIs) to intensify their tight political control over the whole state divestiture process to prevent its derailing from opposition forces.

The analysis focuses on the impact of political control on the privatization process. Some scholars contend that privatization can be successful, regardless of the generally participatory nature of the regime, as long as the policy debate on the breadth and scope of the state divestiture process is restricted. Such an approach to the governance of the process allows the authorities to limit the opportunities for potential opponents to create roadblocks. In the early 1990s many international advisers to countries undergoing such a process stressed the importance of insulating policy decision making to remain within a small group of technocrats

within the executive. This involved granting special powers in drafting and executing market reforms to the executive, often bypassing legislative and judiciary obstacles and creating what O'Donnell (1999) defined as "delegative democracy." Once the executive muted the institutional obstacles coming from other branches of the government it co-opted the potential losers through the offer of compensation mechanisms to potential losers of the state sector divestiture, mainly to labor (through early retirement, retraining, poverty-relief programs) and business (allowing former managers of state corporations to take over their companies in post-Communist countries or allowing former suppliers to keep out foreign competitors like in some Latin American cases). In so doing, the executive would maintain a free hand and a tight control over the policy process.

A politically controlled privatization can, on the one hand, overcome strong opposition in an environment where the anti-reform interests are stronger than the pro-reform coalition (Haggard and Kaufman, 1992; Belev, 2000). On the other hand, however, this makes privatization highly dependent upon the discretion of the incumbent political leadership whose priorities are subject to change over time, thus affecting the initial policy goals and implementation. As a consequence, privatization may not be fully consistent with other important reform measures, or its progress may not necessarily contribute to a genuine liberalization, especially in the absence of matching steps toward a political opening (Hellman 1998, Schamis 1999).

The comparison of the privatization experience of Egypt and Tunisia through a process tracing method, allows one to analyze in a systematic fashion various factors which often cannot be measured statistically. The selection of Egypt and Tunisia rests on the fact that these are countries experiencing divestiture of state-owned assets and functions under strong governments which, in theory, provide the best context for the exercise of political control. Moreover, to enrich the analysis we also make some comparisons with other MENA countries, as well as with the references to the experience of CEE and Latin America. Within this framework our study shows the limitations of tightly controlled privatization when compared to the market reform package as a whole. The effectiveness of a piecemeal policy, which does not pay sufficient attention to the market context where privatization takes place proves extremely limited.

1.4 Privatisation and the financing of local public authorities

Another factor which the literature acknowledges as central to privatisation decisions is the tightness of the budget constraint. While most existing analyses look at central governments, which have been affected by such constraints especially during the process leading to the common European currency, the study carried out has looked at local authorities.

Local bodies are assumed to have some power over taxation and must decide upon some public investments in an intertemporal setting under conditions of revenue shocks. This corresponds to the existing evidence that expenditure demands fluctuate over time, most dramatically because of external security threats leading to wars but, on more modest scales, because of policy changes arising from economic, demographic, technological, and other factors. On the revenue side, fluctuations in incomes, population, and other revenue determinants produce swings in tax revenues over time.

In some cases, unanticipated revenue shortfalls or windfalls may be accompanied by unanticipated changes in expenditures, for example by programmatic adjustments, hiring or wage freezes, or the deferral of capital expenditures, or the reverse. Similarly, unanticipated expenditure needs may be financed through short-run revenue-enhancements such as increases in fees or charges.

Of course, revenue and expenditure flows need not coincide precisely in any given period. As a matter of fundamental fiscal policy, as well as to meet short-run cash flow requirements, governments continuously adjust their financial and non-financial assets and liabilities. When revenue flows are high relative to current public-service provision commitments, governments may accumulate liquid assets, pay off outstanding liabilities, undertake added infrastructure expenditures, or acquire new assets such as buildings, land or other natural resources, or public enterprises. In the face of revenue shortfalls, governments may deplete financial reserves, defer or cancel planned capital expenditures, liquidate public assets, sell public enterprises, or otherwise reduce net assets. Of course, explicit government borrowing also plays an important role in bridging the gap between revenues and

expenditures, as does implicit government borrowing or asset accumulation through the funding or underfunding of pension systems, insurance reserves, and other similar policy adjustments that shift the balance between present and future cash outflows and inflows.

Exactly how local governments manage to determine their long- and short-run policy objectives while complying with basic accounting cash flow constraints in a dynamic and uncertain environment - subject at all times to conflicting political imperatives - is not well understood. The institutional structure within which local bodies operate typically include annual budgeting for expenditures, compliance with accounting standards for the disclosure of expenditures, revenues, and asset and liability acquisitions and dispositions, adjustments of tax and other revenue-generating policies through the actions of legislatures or other governance bodies, and constraints imposed by financial and other markets, all plausibly play some role in determining the evolution of fiscal policies.

In particular, without borrowing restrictions, the optimal policy is characterized by smooth time paths of taxes and public investment. While the introduction of formal borrowing restrictions leads to some precautionary savings, it gives rise to fluctuations in public investment, and hence in privatization plans, in response to adverse (or favourable) revenue shocks. To analyze these issues, a theoretical and empirical analysis of the dynamic evolution of government finances in an explicitly intertemporal setting is developed, within which governments may accumulate or decumulate real and financial assets while facing fundamental economic uncertainties that produce revenue fluctuations

This theoretical framework provides the foundation for an empirical analysis of a 25-year panel of more than 1000 municipal governments in the US. As expected, municipal government capital expenditures depend on lagged fiscal variables that respect long-run fiscal optimization but also on lagged deficits, an indication that the current budgetary condition is an additional determinant of capital spending. Furthermore, these impacts are especially pronounced when municipalities are subject to restrictions on access to capital markets. Capital expenditures are also more sensitive to contemporaneous revenue fluctuations in the presence of such

restrictions, further evidence that the availability of financial tools with which to manage fiscal shocks affects "real" public sector investment decisions.

These results are relevant for a number of policy issues. In particular, it highlights the importance of access to capital markets not only for purposes of long-run optimization of taxation and infrastructure-related public service provision but for purposes of adjustment to short-run stochastic shocks. Even when fiscal policies are optimized over long planning horizons, governments must still adjust to short-run shocks, and, in doing so, they face trade-offs between the pursuit of long-term goals and compliance with short-run constraints. Restrictions on access to capital markets change the financial environment within which long-term decisions are made and implemented as well as the capacity of governments to adapt to temporary stochastic fluctuations.

This result is remarkable given that US local governments enjoy a considerable degree of fiscal autonomy. In this respect, Europe and the US seem to display different dynamics, although probably less than could be expected. A particularly relevant case study has involved Germany, where a large panel of German municipalities is employed in order to investigate the dynamic fiscal policy adjustment of local jurisdictions using a vector error-correction model that explicitly takes account of the intertemporal budget constraint.

Aside from own revenues raised from local taxes and charges, local governments in European countries rely on intergovernmental revenue obtained from higher levels of government. The literature on fiscal federalism has justified this kind of intervention as a means to induce the local governments to provide specific types of public goods, to redistribute among lower level governments, and to ensure efficiency under conditions of intergovernmental externalities. The more recent literature emphasizes, however, that intergovernmental transfers give rise to important questions of governance, since higher level governments allocate funds on the basis of conditions which are subject to strategic choices of local governments.

One important institutional dimension in this regard is the role of fiscal equalization transfers. While most countries assist subnational governments by means of vertical grants, some federal countries, such as Australia, Canada, Germany, or

Switzerland, entertain redistributive transfer schemes that explicitly aim at equalizing revenue capacities across subnational governments. These transfers might be quite effective in providing fiscal assistance in case of adverse revenue shocks because they are formally related to the taxing capacity of a jurisdiction and are not subject to the immediate discretion of policy makers. However, little is known about the comparative performance of these fiscal equalization systems and more standard systems of vertical grants in maintaining fiscal balance and about associated governance problems.

The results confirm that a substantial part of fiscal adjustment is due to changes in intergovernmental transfers: in present value terms about 34 cents of a permanent one euro decrease in own revenues are compensated by subsequent changes in fiscal equalization transfers. Therefore, the contribution of intergovernmental transfers in maintaining fiscal balance is found to be two to three times higher than in the case of US municipalities. Nevertheless, budget components such as own revenues display larger fluctuations in the German case. This supports concerns that the insurance against local revenue shocks provided by the fiscal equalization system is creating a moral-hazard problem.

While municipalities in Germany also enjoy some autonomy in expenditures as well as in taxation they are subject to a comprehensive system of fiscal equalization transfers. Given these differences, the German case offers interesting opportunities for comparisons with the case of US municipalities. The empirical results support the idea that fiscal equalization for budget balance plays a major role in shaping privatization policies at local level. The degree of fiscal assistance provided by intergovernmental revenue is much more significant than in the case of US municipalities. At the same time, however, rather strong fluctuations can be seen in own revenues, which may be related to the strong reliance of municipalities on the business tax (a local profit tax). This suggests that the large amount of insurance provided by the system of fiscal equalization might induce the municipalities to rely more on the volatile business tax rather than using property taxes as the US counterparts.

2 PRIVATE AND PUBLIC CONTROL OF FIRMS

The Project's **second objective** was to analyse the interactions between private and public ownership and control of firms, especially referring to regulated markets and SGI. More particularly:

- a framework to evaluate the trade-offs between private and public ownership and control of corporations, and identify (if any) the optimal government's stake in models encompassing issues of regulatory governance;
- empirical analyses on the evolution of ownership and control structures of privatised firms assessing the long term effect of changes of ownership structure on firm value in OECD economies and in the Czech Republic;
- empirical analyses on the different patterns of ownership and control as compared with the level of divesting government (central, intermediate, local), with special reference to utilities and public services, and taking into account also legal and statutory constraints embodied in the so called "golden share provisions".

2.1 How State control survives privatization

Governments all over the world have either sold or are selling large blocks of their ownership positions in corporations to the private sector. In terms of flows, privatization transactions, including share issue privatization (SIP) and private placements, have raised globally revenues of US\$1,230 billion during the 1977-2003 period, about one fifth of total issuance on public equity markets. Yet, stories in the popular press suggest that the roll back of the State has been incomplete: privatisation and persistent State control apparently coexist.

Governments have often separated ownership and control in privatized companies by means of pyramids, statutory restrictions and special-class shares that grant them exceptional powers. According to recent estimates, European governments own shareholdings in (listed) privatised companies worth approximately €250bn. If

we add to this figure other financial holdings and the value of non corporatised assets, a conservative estimate of State property in the EU approaches €1trn.

Italian privatizations provide a revealing example of this reluctance to relinquish control in State-owned enterprises (SOEs). After the 1992 general elections, when the country was facing one of the most acute economic and political crises of the post-war period, the government decided to launch its first large-scale privatization process. Major privatization deals implemented since 1993 have raised more than \$100 billion, making Italy third in total value of privatizations worldwide (Securities Data Corporation). Despite these remarkable quantitative results, the Italian government is still an influential shareholder in many privatized firms. For example, it holds direct and indirect stakes (through Cassa Depositi e Prestiti, CDP) in Eni (the largest oil and gas company), Enel (the electricity giant), Alitalia (until 2008, the flagship carrier), and Finmeccanica (the aerospace, defence and IT group). It also enjoys special powers to veto strategic decisions and acquisitions in fully privatized companies such as Telecom Italia, the former telecommunication State monopoly. These preliminary observations feed the suspicion that, despite large-scale privatizations, governments still wield power in SOEs.

Our research analyzes whether such a reluctance to relinquish control exists, and how widespread it is. We also study country, industry, and firm characteristics that tend to be associated with government influence over SOEs. Ultimately, this study concludes that government control of privatized firms is not an Italian peculiarity but a common feature of privatization in developed economies.

We show that many privatizations of a SOE are characterized by the sale of equity without a corresponding transfer of control rights. This may happen because the government remains the largest *ultimate* shareholder of the company, although it no longer owns 100% of the stocks, or because it enjoys veto or special powers through its possession of so-called "golden shares." We document this evolution of corporate control by carrying out a comprehensive analysis of the structure of ultimate control (voting) rights in a sample of 141 privatized (publicly traded) companies from developed economies, over the period 1996 to 2000. We find that the most common privatization outcome is that the State remains the largest ultimate owner. This is true for about one third of so-called "privatized" firms.

A few studies employing the notion of ultimate control outside a privatization setting have documented the widespread presence of governments as ultimate owners of banks (La Porta, Lopez-de-Silanes and Shleifer, 2002) or other firms (e.g., Faccio and Lang, 2002). To our knowledge, however, with few exceptions all papers on privatization have at most focused on *direct* ownership. In a recent paper, Boubakri, Cosset and Guedhami (2005) study direct ownership and conclude that governments relinquish control over time. We show that the picture looks totally different when *indirect* voting rights are accounted for. Our methodology in fact allows us to document that in more than 50% of privatized firms in which a government is the largest ultimate shareholder, this government employs pyramids and dual-class share structures to retain majority control. If one did not consider these mechanisms, one would have substantially understated the power of the State in privatized firms.

Consistent with earlier findings by Jones, Megginson, Netter and Nash (1999), a widespread use of control restrictions and golden shares can be documented. These mechanisms are particularly common amongst privatized companies in which the government is *not* the largest shareholder. This combination of evidence allows us to conclude that through ownership *or* golden shares, governments are able to maintain control of almost two thirds of privatized firms. This result is quite surprising, given that conventional wisdom relates the period under study to a drastic rethinking of the role of State ownership which spurred a massive privatization wave: In fact, our evidence indicates that, even in a period during which governments were divesting substantial amounts through the sale of ownership of corporations, they maintained tight control in the majority of these firms.

The instruments used by governments to retain control over privatized firms differ, to some extent, across countries. For example, while governments are unlikely to keep large ownership stakes in privatized firms in common law countries, golden shares are widespread in these same jurisdictions. Thus, there seem to be some substitution in the channels used by governments to maintain their influence over SOEs. We also document larger government control through ownership in countries dominated by a left wing majority, in politically fragmented democracies with proportional electoral rules and in countries with a centralized structure of political

and fiscal authority. When one looks at the combined use of ownership and golden share, one finds no relation between government influence and legal origin. However, political and institutional factors remain significantly related to the frequency of government control of privatized firms. We thus conclude that when it comes to relinquish control, the political fragmentation induced by proportional rules makes the status quo the most likely outcome, and privatization remains incomplete. On the contrary, the delegation of substantial authority to sub-national governments fosters private investment and full privatization.

2.2 State Control after privatisation in the Czech Republic

The evolution of ownership and control structures of privatised firms in transition economies takes up particular features which have been at the centre of a specific analysis.

At the beginning of the transformation process in Central Europe, privatization was largely considered the foundation of the entire transition process. The so-called Washington Consensus emphasized privatization and the belief that private ownership together with market forces would guarantee efficient economic performance. However, it was also often recognized that privatization on its own might not be sufficient and that systemic changes and policy reforms were a prerequisite for successful transition. The transfer of ownership rights was seen by most academics and policy makers as crucial for the efficient allocation of resources and economic growth (Estrin, Hanousek, Kočenda and Svejnar, 2007). Truly, transition economies carried out a major ownership transformation that made the share of the private sector in GDP increase from extremely low levels to between 60% and 90% (see EBRD, 2001 and 2006). They also strived to establish market-oriented institutions and a legal system that would improve the role of the state in providing infrastructure vital to the newly emerging market economy (state governance). Despite the considerable achievements during the first decade of transition, Hellman and Schankerman (2000) showed that good state governance was not established across many transformation economies by 1999.

Privatization schemes in many European emerging economies involved the creation of a special government agency that assumed the role of the administrator of state property. The state often remained the ultimate owner of numerous firms long after

privatization was concluded, a situation that has been documented for the Czech Republic. In the Czech Republic, the National Property Fund (NPF) acted as the governmental administrator of the property that remained in the possession of the state. As the NPF was dissolved at the end of 2005, it is relevant to study the extent of state control potential in privatized firms from a long-term perspective. In this paper, we examine the dynamics of changes in the structure of ownership, the extent of state ownership and the potential for state control in privatized Czech firms over the period 1994–2005, i.e. from the end of privatization to the dissolution of the NPF.

The identification of the extent of state control is important as state control in privatized firms may have potentially negative effects due to several reasons. Shleifer and Vishny (1994) argue that inferior performance (in terms of value maximization) of state firms can be expected because state officials are prone to impose on the management of state companies a variety of goals, such as the minimization of layoffs, political patronage, or protecting other state firms' markets, and these goals differ from those associated with the quest for economic efficiency. Hence, the performance of state-owned enterprises (SOEs) suffers from the above political costs as well as agency costs (Shleifer and Vishny, 1994; Qian, 1996). Further, following other-than-economic objectives, firms with state control are less likely to innovate and restructure their line of production. In this respect, Frydman, Hessel, and Rapaczynski (2006) provide evidence that product restructuring is significantly more revenue effective in firms owned by outside investors than in firms owned by the state or insiders. Restructuring was often delayed in privatized firms where the state retained various degrees of ownership. Bennett, Estrin, and Maw (2005) argue that the state would choose to retain some ownership in order to raise its bargaining power for the later sale of the residual state property and to increase its price. This way a higher sale price was at the expense of corporate efficiency due to delayed restructuring.

Further, direct or indirect state control can provide grounds for retaining or creating a monopoly, which is generally known to produce lower output at higher prices when compared to standard competition. On other hand, monopoly power also poses a dilemma for the state as owner because a firm that is privatized with monopoly power can be sold for a higher price than if it is divided into units to

create a more competitive market structure (Estrin, 1994). Finally, the hardening of budget constraints (i.e. curtailing firms' access to formal or informal state subsidies) is widely accepted to have a positive effect on corporate restructuring. However, soft budget constraints can be practiced between state-controlled credit providers and firms while being hidden by less-than-evident links among firms and financial institutions under state control. Preferential treatment of state-controlled firms by state-controlled financial intuitions constitutes the emergence of a subsidy. Frydman, Gray, Hessel, and Rapaczynski (2000) show that shortly after privatization, firms owned by the state in Central Europe are often unable to perform on par with private firms and are riskier to their lenders as they are less able to repay their debts. In effect, extending soft credit to state-controlled firms likely yields a self-propagating deterioration of corporate fiscal discipline. Despite the importance of the potential consequences of state ownership, addressing this issue on the set of firms we use is beyond the scope of our paper and we therefore concentrate on quantifying the state control.

We quantify the extent of potential state control over the assets of privatized firms in the decade after the end of the privatization period. Complete data about assets, shares and means of indirect control in privatized firms enable us to formulate a relatively decisive conclusion about one phenomenon of the Czech transition which to date, due to the non-existence of relevant data, could not have been studied at the appropriate level. Based on the data analysis, we suggest taking into account the potential of the state to control the assets of privatized firms, since firms in the economy under such potential control cannot be considered truly private. This study supports the conclusion that "the role of the state is far more important than it may appear" at first glance and that "the state is still an indirect shareholder" in "an important sector of the economy".

2.3 Focus on "municipal capitalism"

We have already stressed that the conventional economic approach hinges upon a dichotomy private/privatized company, without taking into account the real complexity of mixed ownership, where control rights are exerted via structures such as pyramids, statutory constraints, and special powers of public shareholders. This has been largely used at local level, where regional and local authorities are very

often present within firms which are said to have been privatised. Public presence is in firms in general is widespread – in mixed forms as well as in pure ones – in the Italian case, which has been analysed in detail.

A recent debate in Italy has stressed the relevance of the so called “municipal capitalism”, i.e. of the increasing presence of firms created and owned by local governments in various sectors. These firms are suspected of being ways on the one hand to by-pass constraints set by public finance laws on the municipalities’ borrowing ability, and on the other hand to distort competition in sectors where local authorities are in charge of public regulation. However, to the best of our knowledge no comprehensive analysis has been carried out to assess the phenomenon, to quantify its economic relevance and to discuss whether it may be considered physiological rather than pathological.

One part of the research output aims at filling this gap. The research first identifies direct and indirect holdings by central and local governments in large and medium-sized Italian firms. A second task is to provide evidence on their impact on economic activity, and on their operating and financial performance.

We can show that more than 400 medium-large firms are participated by local governments in Italy, employing more than 200.000 people, and producing on average more than 1% of total national GDP. In some region this figure rises to more than 6%. The public presence is not limited to traditional “public services” (or services of general interest) but is very common in sectors, which are normally open to competition.

Mixed firms are then compared to totally public firms, showing that in mixed firms not only profitability is higher, but all efficiency indices show better performances.

3 THE EFFECTS OF PRIVATISATION POLICIES

The extant literature has proved that large-scale privatisation programmes may affect dramatically the welfare of several stakeholders in the economy. Indeed, consumers are affected by the pricing policies of privatised companies, especially in SGI. Privatisation has important consequences on taxpayers given that revenues raised can be used to alter the fiscal stance, or to curb public debt. Furthermore, when privatisation occurs in public equity markets, investors will be affected by the financial performance of the stocks of privatised companies. Finally, employees of State-owned corporations are potentially affected by reduction in staff numbers and redundant workers.

Even if in principle the privatisation policy could be designed to ensure an overall improvement in welfare, it has clearly produced strong redistributive effects, paying off well some social classes, and adversely affecting others. These concerns are significant because the poorest segments of society are generally the main consumers of goods and services previously produced by SOEs. The dissatisfaction of part of the public opinion with some of the recent privatisation and liberalisation policies deserve the attention of policy makers and of the research community. So far, economists have mainly been interested on the efficiency of privatisation and liberalisation policies, however distributional aspects of such policies covered by the Project have been thoroughly addressed.

The Project's **third objective** was thus to evaluate the effects of privatisation policies on several stakeholders, such as:

- consumers, analyzing empirically the impact of privatisation, liberalisation and regulation of public utilities on individual and household welfare under different policy regimes, with special reference to SGI such as water supply, gas, electricity and telecommunications;
- taxpayers, studying the role of privatisation in stabilizing the current budget and in maintaining fiscal balance in the long-run both at the local and central level;

- shareholders, evaluating the stock market performance of European listed privatised firms in order identify the risk and return characteristic of this particular investment;
- employees, analyzing the long term effect of privatization on employment levels and wages in selected European countries.

3.1 *The effects of privatization in Transition Economies*

This paper is motivated by the ongoing debate among economists and policy makers about the efficiency and other economic effects of privatization of state-owned enterprises (SOEs). Our goal is to evaluate what we have learned to date about the effects of privatization from the experiences during the last 15-20 years in the post-communist (transition) economies and, where relevant, China.

There has already been one major attempt to survey this literature, by Djankov and Murrell (henceforth D-M) in 2002. These authors concluded that privatization to outside owners resulted in 50 percent more restructuring than privatization to insiders (current managers or workers). Privatization to workers had no effect in CEE and a negative effect in the CIS. Investment funds, foreign ownership and other block-holders were found to produce more than ten times as much restructuring as diffuse individual ownership. Hardening of budgets constraints (i.e. curtailing firms' access to formal or informal state subsidies) was also found to have a positive effect on restructuring. Among other factors, import competition had a positive effect on performance in CEE, but a negative effect in CIS. Overall, D-M noted that the impact of privatization on company performance was typically positive and statistically significant in CEE, but statistically insignificant in CIS. They

suggested that this could be explained by the more widespread occurrence of insider ownership after privatization and a weaker institutional environment leading to less effective governance by outside owners in the CIS countries.¹ Finally, D-M also pointed out that about one-half of the studies they surveyed did not take into account the endogeneity and selection issues associated with changing ownership and firm performance, and they urged future research to tackle this issue.

Our analysis highlights several significant shifts of emphasis in the literature in recent years. Firstly as ownership structures have evolved, research interest has shifted from comparing categories of domestic owners (e.g., insider versus outsider) to contrasting domestic and foreign ownership, to a thorough study of the performance of privatized (as compared to *de novo* enterprises) and of the impact of concentrated v. dispersed ownership. Researchers have also increasingly noted that policies and institutional development have diverged between the CEE and CIS countries, with the former increasingly adopting European Union (EU) rules and joining the EU, and the latter proceeding slower in introducing a market friendly legal and institutional system.

Starting from the macroeconomic studies, we find that the results suggest that privatization, especially when accompanied by complementary reforms, may have a positive effect on the level of aggregate output or economic growth. However, one of the most widely debated issues of transition, namely the effect on aggregate output and growth of rapid privatization (frequently accompanied by dispersed ownership) versus slower privatization (often with more concentrated ownership) remains unresolved.

As to the impact of privatization on total factor productivity (TFP), we find that in CEE the overall effect is mostly positive during both the early and later transition

¹ This was also argued in a short survey by Guriev and Megginson (2006) which related the mixed results on the impact of privatization in transition economies to the slow progress in microeconomic and legal reform, especially in CIS countries.

periods, but that the effect of privatization to domestic owners is quantitatively much smaller than that to foreign owners, and that it is greater in the later than earlier transition period. In CIS, privatization to foreign owners yields a positive or insignificant effect while privatization to domestic owners generates a negative or insignificant effect. In most instances, the estimated economic effect is smaller in the CIS than CEE. Overall, the TFP effect of privatization to domestic owners is weaker than that to foreign owners, takes longer to take a hold, and in the CIS it has been outright negative or insignificant. There are as yet no TFP studies using data from China which employ robust methodologies and perhaps because of this, the available papers find diverse results, with the effect of non-state ownership being mostly positive but sometimes statistically insignificant and sometimes negative.

Concentration of ownership is important, with majority private ownership having mostly positive effects on the level of TFP. The overall positive effect is again driven primarily by foreign owned firms. The effect of majority domestic private ownership tends to be positive but smaller in magnitude. Studies that distinguish between privatized SOEs and newly created private firms suggest that *de novo* firms are more productive than or at least as productive as SOEs privatized to domestic owners. The effect of employee (insider) ownership on the level of TFP is found to be mostly statistically insignificant or in one case actually positive. Estimates of the effects of privatization on TFP growth suggest that in CEE privatization had a positive effect on the rate of change of TFP in the early transition period and that the effect disappears in the later stage.

The effect of ownership on profitability has been estimated mostly in CEE and shows a positive but very small and often non-significant effect of privatization to domestic or foreign owners on profitability levels in the early as well late transformation periods. In the same way, the effect of privatization to domestic and foreign owners on the rate of growth of profitability is (at most) very small. The effect varies across types of ownership, and concentrated domestic private ownership, managerial ownership, and to a lesser extent foreign ownership tend to have a positive effect on profitability, while state keeping a golden share or concentration of worker ownership appear to be unrelated to profitability. The studies of private ownership on profit of firms in China vary considerably in terms

of methodology sample size and findings, with most indicating a positive and usually significant effect.

The effect of privatization on firm revenues, capturing the effect of privatization on the scale of operation of the firm, is mostly strong and positive. In terms of revenue growth, we observe in CEE a high positive effect of privatization to foreign owners in the early period and a small effect in the later period, as well as an insignificant effect of privatization to domestic owners. Overall, the studies of CEE and CIS countries indicate that privatization tends to have a positive effect on the scale of operation, while studies of the effect of private ownership on the rate of change of scale of operations (from CEE, CIS and China) suggest that this effect is not statistically significant except in some well defined categories of ownership.

Estimates of the effect of privatization on labor productivity (not controlling for the use of others inputs) are similar to the TFP results -- the effect of privatization is primarily positive or insignificant. As in the case of TFP, foreign ownership and concentrated ownership are found to have a positive or insignificant effect, while the effects of employee and management ownership are estimated to be mostly statistically insignificant. The corresponding studies of firms in China yield mostly insignificant estimates of the effects of private/non-state ownership on labor productivity.

In terms of the effect of privatization on employment, the estimates indicate that there is a tendency for privatized firms, especially those with foreign owners, to increase or not to reduce employment relative to firms with state ownership. In general, employee ownership and control do not have a significant effect on employment, providing parallel evidence to the TFP studies that this form of ownership does not result in excess employment.

Studies of the effects of ownership on wages find that state ownership is associated with lower wages in some countries, such as Russia and former Czechoslovakia, but not in others, such as Poland. In Russia, where in the 1990s firms tended to owe wages to their workers, SOEs were more likely to exhibit wage arrears than firms with domestic and foreign private ownership, firms with mixed ownership and *de novo* firms.

Studies that have analyzed the effect of privatization on other dependent variables show that (a) privatization results in higher exports and greater efficiency,

as measured by the cost of inputs relative to sales, Tobin's Q, and soft budget constraints, and (b) privatization to foreign firms leads to more restructuring and sale of assets, greater likelihood of payment of dividends, and smaller likelihood of default on debt. These results exhibit a pattern that is in line with the above measures of performance.

3.2 The effect of privatization in emerging markets – a look at micro data

Corporate divestitures (including asset sales, spinoffs, breakups, and carve-outs) play an important part in advanced market economies and they have been widely researched in the literature. The Czech Republic constitutes a particularly useful laboratory for analyzing the effects of divestitures and privatization on financial and economic performance in emerging markets. During the late 1980s and early-to-mid 1990s the country had many features found in other emerging market economies, but the variation in the values of the relevant variables was much greater. Hence, while emerging market economies are usually characterized by a transition from significant to less pronounced state ownership, with divestitures being one of the mechanisms of corporate restructuring, in the Czech Republic these processes were much more pronounced than in most other economies. The country started in 1990 as an almost completely state-owned, controlled and trade-protected economy, with its corporate sector being dominated by large state-owned enterprise (SOE) conglomerates. It rapidly opened itself to trade, liberalized prices and privatized its SOEs, so that by 1995 it was an overwhelmingly privately-owned market economy. In the process, most of the large SOE conglomerates were broken up and the number of the medium and large industrial firms more than tripled on account of numerous divestitures, as well as entry of newly created firms.

The structural and institutional features observed in the emerging market economies in general, and the Czech Republic in particular, have allowed us to test two competing hypotheses with respect to divestitures and privatization:

1. Divestitures and privatization have a positive effect on the performance of the resulting units by eliminating inefficiencies such as diseconomies of scale of large SOEs, weak managerial incentives and information asymmetries that existed prior to economic liberalization and reduction of state control;

2. Divestitures and privatization have a negative effect on the performance of the resulting units because of weak corporate governance, waning government coordination and regulation, unclear property rights, and underdeveloped legal and institutional framework that exist in emerging market economies.

With respect to privatization, we have also tested whether the nature of the effect depends on the type of the new ownership structure. In particular, we are able to distinguish the extent to which each firm is owned by an industrial (i.e., non-financial) firm, financial company, individual owner, or state, and we can estimate the effect of different ownership patterns on corporate performance.

Divestitures and privatization have a number of significant effects on corporate performance. The average divestiture increases the firm's profitability and scale of operations (sales), while the effect of privatization depends on the resulting ownership structure. The overall evidence for divestitures is consistent with the hypothesis that divestitures have a positive effect on performance. Reducing state ownership is positive for some performance indicators but insignificant or even negative for others. Industrial firms as owners improve or do not hamper performance and in that sense they behave consistently with our first hypothesis. Financial companies and individuals as owners are mostly associated with no improvement and in some cases significant declines in performance, thus providing evidence that is consistent with the second hypothesis. The effects of privatization are hence found to be less positive and more nuanced than was suggested in many of the early studies.

This also allows us to raise a methodological point, namely that it is important to control for changes in ownership when analyzing the effect of divestitures and control for endogeneity, selection and data attrition when analyzing the effects of divestitures and privatization.

3.3 The effects of privatisation policy on political risk and asset prices

The government plays a fundamental role in most countries. Acting on behalf the citizens of democratic societies, it can legitimately tax, spend, and regulate economic activity. The size and scope of government varies around the world and over time, and in many economies it accounts for a sizable fraction of GDP. Yet the

broad discretionary powers enjoyed by the State can also hurt economic agents when incumbent governments raise taxes, revise legislation to cater specific constituencies, renege contracts, or exert their powers to interfere in the operating activity of firms.

The effects of the economic activity of the state are not only important and widespread, but also quite unpredictable overtime. Change in voters' preferences may create different majorities in parliament and bring new governments in office. These political shifts can generate backlash against previous policy choices and induce policy reversals. Even during the same legislature, powerful interest groups may push the incumbent government to implement ad hoc interventions and favorable policy changes hurting other stakeholders. Many of these discretionary changes in policy are impossible to predict on the basis of a fixed structural model of the economy. Thus investors must form expectations about the risk that a future political event will change the prospects of profitability of a given investment. This is what economists and political scientists usually define political risk.

Political risk has been predominantly analyzed in emerging markets. An important line of research has established a link between the evolution of political risk in developing countries and the progress of privatization programs. Perotti and van Oijen (2001) and Huibers and Perotti (1998) have shown that the actual implementation of privatization programs has contributed to building investor confidence about political commitment to market oriented reforms. The resolution of political risk obtained through sustained privatization had affected excess returns and domestic financial development.

Our study shows that political risk is also potentially relevant in developed economies with mature financial markets even though it takes more subtle forms than in emerging countries, rendering its measurement more difficult. The typical political risk ratings reported by agencies such as Political Risk Services refer to restrictions on repatriation of profits, exchange controls or other extreme events which are rare occurrences in developed economies. The International Country Guide reports some ratings related to the risk of expropriation and contract repudiation by governments. However, in established democracies these measures do not display any significant variability across countries or over time and as such they become useless tools for empirical analysis.

The recent case triggered by the bid for Suez, the large French multiutility, by Enel, the Italian electricity giant, provides an interesting example of the relevance of political risk in European stock markets. At the end of February 2006, rumours spread that Enel was ready to make an hostile bid for the Suez Group. This news prompted an immediate reaction by the French government who announced a merger plan between Suez and Gaz de France (GdF), the government controlled gas utility. The proposed deal raised the concerns of European regulators for its antitrust implications in the Belgian gas market (where Suez owns the two operators Distrigaz and Fluxys) and its effects on capital flows in the European Union. Italian government also criticized the plan for being an unfair attempt to thwart Enel's interest towards a privately owned firm. Reporting to the European Commission, the French government plainly admitted that it encouraged the two companies to accelerate merger talks.

While financially neutral, the announced plan turned politically costly. The GdF-Suez merger – de facto a re-nationalization of Suez - required the government to overcome a major legal hurdle and to engage in a long parliamentary battle to get the controversial bill amendment pass. To gauge the support of fiercely opposed lawmakers, the French government argued its intervention helped Suez to avoid an unsolicited bid from a foreign company, while the socialist opposition party already announced it would block the deal if it will win the presidential elections in spring 2007. The merger is still on hold and some Suez shareholders are still asking the management to reconsider such government-pushed merger, pointing out that the terms of the deal strongly favor the state-controlled GdF. This example suggests that political risk matters also in developed economies as the profitability of companies traded in the stock market may be affected by sudden government actions.

However, government intervention also affects assets which are not traded in the stock market. When we take the point of view of financial investors, we should ask what reallocations, if any, should be made to the optimal portfolio to account for political risk. Merton (1969, 1971) has shown that the optimal asset allocation depends on the level of the state variables determining the investment opportunity set. For example, as illustrated by Campbell and Viceira (2002), the share invested in stocks depends not only on the risk of stocks and risk aversion, but also on the

covariance between stock market returns and changes in the state variables. The resulting hedging component is in general a very sizeable portion of total stock demand on the part of each rational individual. A state variable representing profitability of non-traded capital may deeply affect the optimal asset allocation. This highlights that political risk is relevant for stock demand not only due to direct intervention on publicly traded companies but also because of intervention on private companies. Any non-diversifiable risk systematically affecting the investment opportunity set of investors affects demand and, in equilibrium, is recorded into stock prices and expected returns.

In our view, the issue is not if there is a risk premium component associated with political risk but how we can measure it and how large it is. We claim that it is possible to find a suitable proxy for political risk by looking at companies which have been privatized to some degree. Our central hypothesis is that privatized companies – such as Suez – are particularly sensitive to systematic political risk factors. Indeed, there are historical reasons why certain firms used to be under public control and governments may try to regain political influence in these companies after privatization. First, SOEs are typically large firms with a broad clientele, they often provide services of general interest and manage strategic infrastructures with high sunk costs. As such, they are severely exposed to political interference in the form of expropriation of quasi-rents. Second, privatized firms can also be used as tools in domestic or foreign policy in order to raise fiscal revenues, to absorb unemployment, to please consumers with affordable tariffs and universal service, and to preserve national security in strategic supplies. Finally, the pricing of the shares of privatized companies can also be designed to achieve key political objectives, notably re-election (Biais and Perotti, 2002). A typical channel through which governments may affect the operating activity of the firms is regulation which can be easily captured especially when regulators are not fully independent from the executive.

The extent to which privatized companies are exposed to systematic political risk depends broadly on the degree of political accountability and commitment provided by one country's institutional setting. However, idiosyncratic factors such as the level of residual state ownership in the firm should also matter. Perotti (2004) has shown theoretically that residual ownership in a privatized firm can serve as a

commitment device to mitigate political risk. In a game with incomplete information about government's preferences, by keeping a stake a market-oriented government can credibly signal its willingness not to interfere in the operating activity in the firm because it would suffer a loss. A populist government will instead sell all its capital upfront exposing immediately the company to the risk of political interference. Then fully privatized firms should be more risky than companies where governments keep a residual stake, and as such they should yield a higher expected return.

In our analysis, we have tested the effect of residual state ownership and control on the expected returns of privatized companies. We track the evolution of government control rights in firms privatized in EU15, and study the long run performance of several portfolios built on different quartiles of government control rights for the 1995-2005 period. Using the time series multifactor regression approach of Fama-French, we find that the portfolio based on the bottom quartile of government control rights - comprising fully privatized companies - significantly outperform portfolios formed by stocks with higher government's residual stakes. The difference in annualized average returns ranges from 5.9 to 3.8 percent.

If a political risk premium can be identified on the basis of residual state ownership in firms, the issue becomes to test whether this factor can capture sensitivity to a common and thus undiversifiable risk affecting asset prices. In other words, we are interested in testing whether a "political risk beta" explains the expected returns of a fully integrated area such as EU15.

A methodological problem is that there is not any accepted model to price risk in European stock markets. Following Fama and French (1994), we build 25 size/value portfolios using the constituents of a broad European index (the Dow Jones STOXX Total Market Index) and then test alternative asset pricing models. Our time series and cross section regressions yield a strong rejection of the CAPM, and a rejection either in time series or cross section tests of conventional multifactor pricing models. However, when these models are extended to include our factor loading for political risk, we obtain intercepts which are close to zero in cross section test and a positive premium for political risk. We conclude that a low level of residual state ownership may proxy for sensitivity to common and thus undiversifiable political

risk factors, and that the notion of political risk beta is useful for a better understanding of returns of European equity markets.

3.4 The perception of reforms of Services of General Interest: the viewpoint of consumers and experts

In sectors supplying services of general interest privatisation has been widespread in Europe and other countries, and it goes hand in hand with regulatory reforms and liberalisation. However, in some cases the perception of consumers is that the outcome of this exceptional amount of reform effort is not totally satisfactory. The research question addressed in a part of the analysis is thus whether European consumers are happy with the services provided by the utilities after two decades of reforms.

While the empirical literature has usually focussed on changes in efficiency of the industry, rather surprisingly the research on the impact of utility reforms on consumers is less developed (with some notable exceptions, such as the research by Catherine Waddams and associates, see e.g. recently Brazier et al 2006, Giulietti et al. 2005). Moreover, most of the empirical literature on this subject deals with individual countries, because of the difficulty of working with comparable cross-country evidence.

While applied welfare economist would turn to objective evidence as their first choice of data for empirical analysis and evaluation of reforms, our study has explored perceptions by consumers, i.e. subjective data on happiness with three dimensions of services of general interest (SGI): accessibility, price and quality. Thus we have not directly studied whether utility reforms explain variations in welfare of consumers across countries and time periods, but whether they are correlated to their perceptions. There are two reasons to consider data on social attitudes. First, because they are important per se. Policy-makers and regulators are well aware that SGI reforms are in the forefront of public debate in the European Union (the widespread concern about the Bolkenstein Directive on the liberalization of services being a clear example).

Second, subjective data can be a complement to objective evidence in order to evaluate the welfare impact of reforms. Ideally, for example, one would use both detailed microdata on price paid and expenditure by households, or on objectively measured quality, along with individual attitudes on these dimension of SGI, to test economic welfare change and compare them with 'happiness' measures. If the two measures do not correlate, this fact would need further research to understand whether the cognitive process by the consumer is biased, or whether the objective statistical evidence does not capture details in SGI provision best known to the user (e.g. aspects of quality, or of price discrimination not reflected in average price indexes).

While in a related research work we explore the combination of objective and subjective evidence to evaluate utility reforms, in this paper we focus exclusively on attitudes. We use three waves of Eurobarometer Surveys, 2000-2002-2004, for the EU 15 countries, and try to test the impact of privatization and regulatory reforms on attitudes of users of electricity, gas, telephone, water.

Although an unconditional analysis across countries points out that some countries, notably Italy, Greece and Portugal show a significant extent of dissatisfaction, once one controls for individual and country fixed-effects the picture is significantly more complex. While some individual characteristics in the samples, and some macroeconomic controls may contribute to explain the degree of satisfaction in Eurobarometer surveys 2002 to 2004, the impact of regulatory variables is also notable. Notice however that disentangling the perception of privatization from those of liberalization proves extremely complex. Among the main conclusions, we can list the following.

- a) Rather surprisingly, for telephone price and for electricity access, price and quality, consumers' satisfaction is higher in countries where public ownership is large, but the reverse is true for gas.
- b) One obvious measure of liberalization is the market share of the incumbent, and one would expect that the smaller such a share, the more competitive is the market, the lower the price for a given quality, and the higher the access, hence the higher consumers' satisfaction. This expectation is rejected by data for gas quality, where satisfaction is positively correlated with the market share of the

incumbent, and in the other cases it is not significant.

- c) A second liberalization variable is 'free entry': this works as expected for telephone access and gas price, but not for telephone price, gas access and quality, and electricity quality.
- d) Vertical integration has a negative impact if any for gas services satisfaction, but a positive one for electricity services.

Taken together, these results may indicate that the economic, institutional and social environment that shapes attitudes towards services of general interest, is a complex one. Any expectation of a simple increasing relation between consumers' satisfaction and the extent of reforms is not supported by the available evidence.

Notice that as privatisation was probably mainly driven by concerns for Government revenues, it may be hardly surprising that consumers are not totally happy with the result. However, it is hard to tell whether this dissatisfaction has to do with a well founded perception of the current situation, or rather by the fact that citizens in many countries feel less protected by the combination of privatisation and regulation than by direct public ownership. Moreover, the devil is often in the details, and a reform process which appears to correspond to international best practices may be harmed by aspects which a comparative analysis may or may not be able to fully incorporate.

In all cases, notice that any analysis of the consequences of privatisation (and reforms) would require a counterfactual exercise which is hard to construct in general cross country analyses.

However, it is interesting to see that analogously "non enthusiastic" opinions have been recorded in the interviews among numerous business and opinion leaders across Europe. The survey was sent out to 300 country specialists (managers and professional analysts) throughout Europe. Finally, 113 experts from 22 European countries participated (a response rate of 38 percent; many of the experts who did not participate in the survey indicated that they were not well informed on privatization). Since Germany provided the highest number of respondents, the results reflect a corresponding German weight.

The survey tackles some ex ante considered important privatization topics such as judgements about privatization effects on:

- Consumer prices
- Wages
- Value of shares
- Employment
- Quality consumer choice

The survey revealed that according to the surveyed experts prices throughout Europe have, except for telecommunication services, not declined significantly due to privatization. As shown in the graph below a majority of the experts believed that energy prices have even risen after the privatization of the former incumbents (above the level of the international market price for energy). When asked about the development of prices in the water and gas sector most of the experts either stated that prices have not changed significantly or claimed that prices like in the energy sector have risen too after privatization. These findings reveal that falling prices for consumers, a popular claim of privatization supporters, has not yet been fulfilled in most of the utilities. The experts of most European countries stated that due to intensified competition and technological change in the telephone sector, the consumer prices decreased drastically.

When asked about the development of wages after the privatization process around half of the experts stated that privatization has not brought about a significant change. However, overall more experts claimed that wages have risen after privatization than fallen. This does not hold for Germany in which case more experts claimed that privatization has resulted in a fall of wages in every sector of the utilities. In fact the survey revealed, that compared to other EU member countries, the average wages in Germany decreased, according to the judgements of the experts, in all 4 sectors, particularly in the telephone sector.

The majority of the experts confirmed that the shares of the former incumbents have gained value due to privatization. They affirmed, as can be seen below, that this is especially true for the telecommunication and energy sectors. Unlike other EU member countries, the value of shares of German enterprises in the telephone sector did not rise; in the other sectors, particularly the electricity sector share prices rose both in Germany and in other EU countries.

When questioned about the effects of utility privatization on employment, the experts drew a relative negative picture. On balance in all EU member countries

privatization led to a decline of employment. The experts rated the negative effects on employment to be most controvert in the telephone sector where 48 percent of the experts claimed that privatization led to a decline of employment while 36 percent claimed that employment has risen. In all other sectors the opinion is dominated by the reception that privatization either had no consequences on employment or led to a decline (the later in-depth survey showed that experts distinguish between long term macro effects and short term micro effects. In the short run the negative judgements prevail, in the long run more often positive effects).

Overall the experts drew a positive picture regarding the effects of privatization on the quality of services and consumer choices. On account of growing competition, the quality and consumer choice increased particularly in the telephone and electricity sector. However, except for the telecommunication sector more than 50 percent of the experts stated that quality has not improved in the gas, water and electricity sector.

4 POLICY IMPLICATIONS: MAKING PRIVATISATION DELIVER

Drawing some comprehensive policy recommendations on the issue of privatisation is an important final aspect to consider. The following recommendations are strongly based on economic rationales, but will also take into proper account the political and institutional constraints facing policymaking.

Although privatisation is a different phenomenon, in particular in the sector of the Services of General Interest (SGIs) privatisation and liberalisation are strongly related. The different understanding which different Member States have of the notion of SGI and the different answers on the issue of their liberalisation may lead to different ways to privatise firms in these sectors. Thus, the strategic policy questions we want to answer are:

- what principles should guide the overall approach to privatisation;
- what political and institutional factors favour the implementation and sustainable large-scale reform programme, with special reference to SGI;

- what is the appropriate role of national and sub-national governments in shaping the divestiture process, how to deal with the potential conflict emerging at a different level of jurisdiction;
- to what extent privatisation may contribute to the creation of a Single Market and especially to the integration of European securities markets;
- how an appropriate management of privatisation can improve the credibility of regulatory policies aimed at improving the competitiveness of the European economy;
- how the complementary liberalisation and regulatory policies should be designed to make privatisation deliver the most desirable outcomes
- how the liberalisation of SGI-markets could lead to new models of public-private-partnership;
- how should privatisation be designed to minimise the adverse social effects and the impact in terms on distribution of wealth.

The aim of this paragraph is to present an overview of the most important phases of the privatisation process. It will deal with the legislative and institutional level of responsibility for privatisation, with the choice of the privatisation candidates, with the restructuring decisions, with the valuation of the SOEs and finally with the choice of the privatisation methods. All these aspects are important parts of the entire privatisation program and must be taken into consideration to develop a whole and complete selling procedure.

Notice that the question of how to make privatisation “deliver” requires one to specify the objectives of this process. Although one cannot single out only one relevant objective, at least the relevant trade-offs should be investigated, in order to clarify which aspects of the procedure are most relevant in each direction.

4.1 The institutional set-up

Before deciding which assets to sell or sectors to include in the privatisation program, a government must set the legal framework for privatisation. Building such framework in an appropriate way is a crucial aspect of the process.

First of all, finding the right balance in the relationship between the parliament and the institutional actors has been a key issue in privatisations. Many parliaments are reluctant to delegate broad powers to the government or to other subjects, but a great involvement of the parliament in the process can slow or even block its development. On the contrary, broad delegation of powers may speed up the process, but usually requires either a strong executive or a wide-ranging consensus between parliament and the government on the policies to be pursued.

In the same way, setting an appropriate balance between politics and administration is equally important. Political decisions should be confined to the main architectural features of the programme, and probably to the identification of the objects to be privatised. Without denying the political relevance of other parts of the implementation of the programme, however, continuous political interference should be avoided with a proper delegation of powers.

In this perspective, the privatisation process may give birth to new institutions needed to manage different phases of the transactions, even if there is not an ideal or universal institutional model or blueprint; institutions have to be tailored to specific needs and environments. Specific institutions may be set up to act as executing agencies for large national privatisation programs: restructuring agencies, valuation agencies; institutions that control the transparency and correctness of the procedures of sale with the intent to minimise the fraud or corruption; agencies that control the fulfilment of the eventual obligations imposed to the buyers in the sale agreement and privatisation funds that can enable to avoid the atomisation of shareholding, give small shareholders greater voice in corporate bodies, improve corporate governance, and develop financial intermediaries and markets.

Whatever the chosen institutional structure, certain conditions have always to be met for a successful privatisation program. For example, to avoid the risk of congestion, responsibilities should not be dispersed among many separate entities, and the allocation of overlapping responsibilities to competing agencies should be avoided. Finally, all the subjects involved in preparing the privatisation need to be given the right incentives (financial rewards as well as penalties), must be held accountable for their actions and should have adequate skills. When government staff and civil servants do not satisfy these requirements, private sector advisors

with technical, economic, financial, and legal expertise necessary for executing the privatisation program should be hired.

4.2 SGI's and the role for the State

After the implementation of the legislative and institutional framework for privatisation, the very first step a privatising government must take is to decide which state-owned enterprises and sectors should be slated for privatisation. This choice can be extremely difficult and contentious², especially when the political context is very fragmented.

A privatising government facing sharp opposition typically may decide to start its privatisation program by selling companies that are deemed easy to privatise and delaying the disposal of companies that can be considered difficult to sell off. The first group usually encompasses small industries operating in (at least potentially) competitive industries that eventually require only a small capital investment or a light operational restructuring before privatisation. The second group, instead, traditionally includes large industries operating in monopoly markets that require greater preparation prior to sale: a special regulatory framework that balances the need to protect consumers from monopoly pricing, the need to protect the property rights of investors and the need to give the companies incentives to invest in improving service levels³.

² M. BOYCKO, A. SHLEIFER and R. W. VISHNY, *A theory of privatization*, in *Economic Journal* 106, 1996, pp. 309-319; W.L. MEGGINSON, *The Financial Economics of Privatization*, Oxford University Press, Oxford, 2005, p. 69.

³ See: M. BORNSTEIN, *Framework issues in the privatization strategies of Czech Republic, Hungary, and Poland*, in *Post- communist Economies*, 11, 1999, p. 56 .

In managing SOEs governments often try to pursue potentially conflicting objectives of social and commercial nature. In order to solve this problem, a change in the role of the State may be appropriate: the state and its regulatory institutions could take care of the public interest and of the quality of the service (the social objective), while the firm owners could be private, profit-oriented shareholders pursuing profit maximisation and assuming the commercial risks associated with the economic activity (the commercial objective). In this way, the government would cease to produce services and goods and may take up the role of the regulator and the supervisor of their quality and provision. Specific contractual obligations and sanctions can be introduced in the privatisation law or in the selling agreement to force the new owner of the privatised companies to fulfil specific standards of quality and distribution. Within this approach, given an appropriate regulatory framework, there is no reason why also public utilities and companies considered "strategic" could not be privately owned. In other words, privatisation may extend effectively even to activities traditionally reserved for the public sector. Establishing that something can be privatised does not mean that it should be privatised. In each instance, the costs and benefits of public versus private provision of a given service, including the associated transaction costs, as well as economic, financial, political, and social consequences of the planned privatisation should be analysed.

Privatisation is probably the obvious solution only when the commercial/profit related objectives are predominant and can be separated from the public interest objectives in a meaningful way. When the commercial objectives are limited compared to the public interest, the case for privatisation is less clear cut. Therefore, the possibility to separate commercial and non-commercial objectives is one of the key elements that must be considered in deciding which companies privatise. Moreover, even when this separation is hypothetically possible, its benefits should be weighed against the costs of writing increasingly complicated regulatory/contractual arrangements *ex ante*.

4.3 The sequencing decision

Another important policy decision that a privatising government should take is the order by which assets are privatised. The question is whether privatisation of certain assets should precede that of others, and if so, according to what criteria. This aspect can be particularly important for the privatising government in order to build reputational capital with investors and domestic support for the privatisation program. Successful privatisations, in fact, can help government to build credibility for the program, both with potential investors and with the public. They help to demonstrate government commitment to the policy, its ability to address policy issues and to execute sales efficiently. In order to meet this objective, in the European countries the sequencing decision has often been based on the quality of the assets (with companies with good performance being privatised before companies with poor performance), and on the complexity of the assets in terms of their market structure and the need for a regulatory framework (with assets in competitive markets being disposed off before assets in non-competitive markets). For this reason the sale of public utilities has typically been carried out later in the program to allow time for company and sector restructuring and to develop an effective regulatory framework when competition cannot be introduced.

An important and difficult decision that most governments confront early in any privatisation process is whether an SOE should be restructured before divestment in order to create a viable commercial enterprises. This is a debated issue in the privatisation literature, and any government should face the problem considering the goals it wants to achieve through the privatisation program, the characteristics of the buyer and of the SOE and the chosen method of sale.

The general objective of the restructuring phase is to render the candidate company desirable for potential investors. The firm should be seen by the investors as a credible entity with a financial and operational structure that enable it to achieve its goals. For this reason a reorganisation of the financial and operational dimension of the company could be needed. Writing off government loans and transferring important financial obligations such as unfunded pension liabilities from the SOE to the government, together with changing the politically-appointed board of directors, putting the usually overstuffed workforce of the SOE back in its right perspective and making financial investments to modernise buildings, infrastructure

and plants of the firms are some of the most common interventions that a government can contemporaneously carry out during the restructuring phase.

To render this phase effective, however, governments first of all need to carry out a general mind-changing in managing the companies chosen. During the restructuring phase governments should commit to hard budget constraints, to establish performance contracts which tie managers' remuneration to the performances of the company, to enhance the manager's independence, and to abolish all preferential treatments of SOEs. The playing field should be levelled for these enterprises and those in the private sector. If this does not happen, all the (financial and operative) restructuring efforts described above may be jeopardised by the soft-budget constraints that would continue to be imposed on the company to be privatised.

4.4 Privatisation methods

Several methods of privatisation have been used, and the choice depends on a long list of variables which can include: the specific characteristics of the SOE; the history of the country; the domestic legal, economic and financial environment of the country and the objectives of the privatisation program. It is possible to single out three main privatisation methods:

1. restitution, which was particularly used in the Eastern countries;
2. voucher privatisation, which involves the distribution of vouchers free of charge or at a nominal price to eligible citizens, who can then use them to buy a stake in privatised companies;
3. sale of state property in the form of
 - i. private sales – sometimes in the form of management and employee buy-outs;
 - ii. public offerings.

Restitution is appropriate when land or other easily identifiable property that was expropriated in the past can be returned either to the original owner or to his or her heirs without too many delays or legal complaints. This form of privatisation is

rarely observed outside Eastern Europe, and its economic impact is relatively straightforward.

Something similar can be said about voucher privatisation, although its impact has been far larger than the one of sheer restitution.

4.4.1 Voucher privatisation

The choice of vouchers was due to a combination of (i) the aim to privatise large enterprises quickly but (ii) the desire not to sell them exclusively either to foreign investors or to the incumbent management, and (iii) the lack of functioning capital markets. The programs implied the transfer of the ownership of public assets to eligible citizens through the public distribution of vouchers free of charge or at a nominal price.

This helped to build a reasonable political consensus, and made privatisation politically irreversible since it allowed a certain percentage of the population in each country to become effectively capitalists.

Compared to the expected objectives, the record on voucher privatisation has indeed been quite poor. The cash inflow was almost nil, while especially privatised companies needed new capital for their sustainability. Small investors have immediately sold their shareholdings to people that had the available funds in order to realise a quick capital gain. Most of the time, the buyers were the previous managers of the privatised company who, in this way, became the new company owners. Finally, the governments often retained effective control of the banking sector and these banks continued to suffer political influence, so that even privatised firms continued to face soft budget constraints for indefinite periods.

The empirical record suggests that some steps should have been taken in order to enforce a more efficient voucher privatisation program. First, and most important, governments should have divested their holding in state-owned banks, thus creating a credible hard budget constraint for privatised companies. Second, they should have passed corporate governance reforms, workable bankruptcy legislation and should have established effective and efficient courts to protect shareholders' and creditors' rights. In particular, corporate governance mechanisms should have disciplined self-dealing by managers and controlling shareholders. Finally,

governments should have controlled firms carefully once privatised, while building the legal and market institutions to control self-dealing.

In the future, it is doubtful that new countries will decide to start voucher privatisation programs. Nowadays, most countries have financial markets that give them other alternatives. As the drawbacks of voucher privatisation programs have clearly offset their benefits, whenever it is possible, selling each firm in a separate transaction is clearly a better strategy.

4.4.2 Sale of state property

The sale of state property can take two forms. The first is a partial or total private sale of state owned enterprises to an individual, an existing corporation or a group of investors. The second form is a share issue privatisation (SIP), in which the government sells some or all of its holdings in an SOE to investors through a public share offering. This latter form is similar to an IPO in the private sector, but whilst private IPOs are structured primarily to raise revenue for the company, SIPs are usually structured to raise money for the divesting government and to achieve political objectives.

The choice of whether or not to use public capital markets is based not only on the revenues that the seller (in this case, the government) can receive through one or the other methods but also on other factors, such as the development of the capital market, the political and legal environment of the country, and the specific characteristics of the firm.

As for the first category, some considerations may suggest that when the domestic capital market is not well developed, private sale is a more appropriate method of sale than SIP. On the other hand, however, governments may be willing to sacrifice some of the proceeds in an effort to spur the growth of rising financial markets. In fact, a carefully structured and well-articulated program for privatising major state-owned entities, combined with efforts to establish a suitable regulatory and legislative framework, can give a stock market the needed boost in size and quality. In some cases, even a single privatisation can have this effect, creating a base of domestic retail investors, encouraging the establishment of domestic investment institutions, and attracting, for the first time, foreign investors to the country. Thus, the relation between capital market development and choice of privatisation technique is ambiguous and depends on the objectives that the government wants

to achieve. Finally, the current level of market valuation may be an additional critical factor in a government's choice between private sales and SIPs. Just as a private firm attempts to time the market with its IPO, a government might be more likely to privatise by SIP during periods of high valuations or hot markets and to choose a private sale during periods of depressed stock valuations.

As for the political and legal environment, the Government's stability is the first fundamental variable. On the one hand, it may affect the investors' perception of a nation's commitment to policy. The orientation of the governments may also be relevant. Right-wing governments, in fact, are generally deemed to be less intrusive (i.e. their commitment to protect private property rights in general is considered higher) than left-wing governments. Thus, there could be a positive relation between right-wing governments and investors' willing to buy.

The protection of investors' rights, instead, can be considered an important variable that influence not only the investors' willing to buy but also the government's choice between selling a SOE in the public capital market or in the private capital market. According to La Porta et al. (2002), in fact, countries with stronger protection for minority shareholders have a higher company valuation and a lower concentration of ownership. Thus, since investors in SIPs would be predominantly small shareholders, SIPs should be more frequent in countries providing stronger legal and political protections for minority positions.

Finally, firm-specific characteristics play an important role in the choice of the privatisation method too. Like private firms seeking external funding, governments usually consider the amount of uncertainty regarding the value of the SOE prior to selecting the privatisation method. In choosing between private sale and SIP, privatising governments can consider the degree of information asymmetry about the value of the asset to be privatised and usually are more likely to use private sales when it is more difficult to value the enterprise.

The expected post divestment performance of the SOE may also influence the government's choice of the privatisation technique since the public perception of the newly privatised firm's performance is important to the success or failure of the privatisation program. In this perspective, share issue privatisations involve the greatest amount of reputational risk for the state, because the sales are frequently preceded by extensive promotional campaigns and often create thousands of small,

first-time shareholders. These shareholders, in fact, are also voters and, if the results of the privatisation policy are not satisfactory, they can express their dissatisfaction towards government by not confirming their confidence in the successive elections. Private sales, instead, involve fewer investors and much less public scrutiny. As a result, from a political point of view, SOEs that are expected to perform well should be divested by SIPs, while SOEs with a more questionable future should be privatised by private sales.

The industry where the SOE operates may be a relevant factor in deciding whether a government privatises through an SIP or a private sale. Industries such as defence, transportation, and energy could be of such strategic significance that foreign ownership may be unacceptable. Governments may be more likely to privatise "strategic" firms through private sales, since this method allows them to negotiate particular terms in the contract sale and to establish, for example, a period of mandatory ownership for the (usually) domestic buyers, so that they cannot sell their strategic firms to other (usually foreign) investors. A SOEs' size is another important variable. The larger the SOE, the more likely it is to be sold through an SIP, which entails considerable fixed costs.

An ideal method for valuating and pricing the company to be privatised does not exist, but some important principles can be kept in mind during these phases. The methods of valuation and pricing should be transparent, rigorous yet flexible, adaptable, realistic and in conformity with generally accepted principles; in their choice it is important to bear in mind the numerous, and often interlinking, factors that may have an impact on these phases. In particular, transparency is a fundamental prerequisite for the pricing decision, because the selling price is often a source of criticism. Perceptions of conflict of interest and charges of corruption can severely undermine the credibility of the privatisation process with potential investors and erode public acceptance of the policy, both of which can jeopardise the program and set back reform efforts.

Private sales

If a government decides that a private sale is the optimal method of privatisation, it faces a series of strategic decisions that depend on the objectives it desires to achieve. In particular, governments face some key decisions.

1) First, it must decide whether to conduct all aspects of the sale itself, or to delegate some of the key tasks to an investment bank. Hiring reputable third parties to value and conduct due diligence on the asset being offered for sale has obvious advantages: it increases the credibility of the sale and helps ensure that it is perceived as being conducted honestly. Globally active banks and accounting firms can also attract international investors to a private sale that would otherwise be of interest only to local investors, with obvious consequences for net sales proceeds. On the other hand, third-party facilitators (especially international banks and auditors) tend to be very expensive and their involvement almost inevitably slows down the sale process. On balance, most governments usually have used third parties only for large and profitable private sales.

2) The second strategic decision a government using private sales must face is whether and how to structure the selling terms in order to maximise the sales price and achieve other political and economic objectives. For example, governments can require the acquirer of the SOE to commit to make specific capital investments, to reach/maintain certain quality standards and to meet strict service improvement goals. Governments can also require the purchaser to insure certain levels of staffing or preserve certain business activities. Because of their characteristics, private sales uniquely lend themselves to the use of such mandates in sales contracts. Of course, these performance or social mandates are not cost-free, and the more onerous the mandates, the lower the price received by the government. Certain mandates, especially those maintaining staffing levels, might scare off potential bidders who might otherwise make attractive offers.

3) The final strategic decision a divesting government must take is whether to conduct private sales through competitive biddings (auctions) or direct negotiations with pre-selected potential buyers. If the revenue-maximizing answer is probably obvious (auctions), governments often prefer to conduct direct negotiations in which they can more easily achieve different objectives.

Private sales have advantages and disadvantages. They are typically carried out with minimal legal restructuring, require less planning and can be executed much more rapidly than SIPs. In terms of prerequisites, private sales also have the advantage of being feasible in the absence of a well-developed and sophisticated

market environment. Furthermore, private sales can be used to attract foreign direct investment into a country. When absolutely necessary, they can also ensure that truly strategic assets remain in domestic hands and allow governments to craft sophisticated sale terms to meet political, social, and corporate governance objectives. Finally, other benefits of private sale are the managerial and technical know-how they can bring and the stable investment environment they can insure for an economically important firm/sector.

Though private sales offer key advantages, they also have several disadvantages relative to SIPs. First, private sales typically yield significantly lower sale proceeds than do comparable share issue privatisations and may not always result in the highest quality buyer. Second, private sales do nothing to promote development of the national stock market. Third, in terms of process integrity their main drawback is that they do not provide the same degree of transparency as public offerings and therefore they may potentially be prone to corruption, in particular when they are conducted through non-competitive processes. In this context, a fully transparent process and the establishment of clear and detailed procedures for conducting negotiations and selection of buyers can go a long way in alleviating such concerns and help to protect the integrity of the process. Finally private sales to strategic investors are especially vulnerable to competitive failings. The state is often tempted (or entrapped) into selling its controlling shares to local interests, with negative results for competitiveness; this is especially the case when companies to be privatised are in sensitive sectors (i.e. utilities) and they are also not big enough for an international public floatation. That is why it might be advisable to require the involvement of competition authorities in the design of large private sale transactions.

After a private sale or a share issue privatisation or a voucher privatisation, managers and/or employees of the privatised company may become its owners through the transfer of ownership to a new legal entity in which they are significant if not majority shareholders. These practises, however, can be assimilated to a privatisation method when, as occurred in many states, they are widely facilitated by privatisation programs that provide strong incentives for insiders' ownership. In some cases, in particular, governments can also decide to sell directly a company to its managers and employees through a privatisation buy-out. In these cases, the

buy-out is basically a trade sale in which the acquirer is a team of the enterprise's current management, or the management together with the other employees. These subjects may have financial backing from an external investor as they are unlikely to have enough capital themselves to be able to buy the enterprise.

Buy-outs can involve a variety of organisation forms with various groups of equity holders. The main distinguishing criteria are whether ownership is by management alone (a management buy-out, MBO), evenly spread across all employees (an employee buy-out, EBO), by inside managers and employees (a management-employee buy-out, MEBO), by managers entering the ownership of the firm from outside (a management buy-in, MBI), or by a combination of both outsiders and insiders.

In OECD countries, privatisation buy-outs typically involve the sale of assets and shares. In privatisation buy-outs, the government may dispose of all or part of the equity of an entity, in the latter case retaining an equity stake which may serve to reduce the need for external finance and/or to exert continuing influence over the firm. Privatisation buy-outs may also involve the sale of whole enterprises, the divestment of divisions and the break-up of an entire enterprise into many parts. In some transition economies, assets may be leased to management, with or without the option to buy, or may be virtually "given away" through voucher mechanisms. In a voucher buy-out a proportion of the shares in an enterprise are made available to employees either in return for vouchers that have been issued for free to them or at a preferential rate for cash, or both.

Privatisation buy-out is a goal which has been used occasionally in Western countries, although it has been more common in Central and Eastern Europe. It has been particularly popular in Russia, where the rules allowing workers and management to purchase shares were such that they received a large discount on the true value.

The extension of shareholdings to the wider body of employees to some extent converts employees from agents into principals. The theoretical result is closer alignment of employees' goals with those of equity-holding management and any outside investors leading to improved incentives for enhancing productivity and performance. By becoming shareholders, employees may be encouraged to monitor

themselves, reinforcing the vertical supervisory structure. The extent to which employee ownership in a buy-out generates these benefits, however, depends on the relation between their salary and their investment in the company. It is evident that if an employee does not invest large sums in the company, as a shareholder he will try to protect his own job security and to gain more benefits for his working condition even if these benefits may have detrimental effects for the company considered as a whole. If an employee, instead, invests a large sum to acquire shares of the company in which he works, probably he will pay more attention to the economic and financial situation of the company in order to obtain a high capital gain when he will sell his shares. In both situations, however, adequate corporate governance mechanisms may be necessary to prevent possible negative effects of buy-outs. Management without adequate skills to efficiently manage the company, in fact, may enforce illegal practices (such as asset stripping or tunnelling) to get rich to the detriment of the company value. Thus, self-dealing transactions should be disciplined to prevent managers from expropriating and looting companies' value.

Privatisation buy-out may also affect the restructuring decision. In the absence of outside pressure, the extent to which restructuring will take place depends on the motives for insiders to purchase shares. Management and employees may acquire shares for insurance as well as for equity investment purposes. In the former case restructuring is expected to be low as insiders seek to protect their benefits.

Finally, privatisation buy-outs may also give rise to other criticisms in regard to distribution of fairness and efficiency gain. As for the first issue, preferential share prices for employees may be criticised because they favour workers in some enterprises over the rest of the population. As for the second issue, in particular in transition economies, buy-outs may be criticized because they transfer ownership rights to insiders that may lack many of the required skills to succeed in a market-oriented economy.

As usual, the choice of favouring MEBO depends on the characteristics of the entity to be sold and, most importantly, on the relative importance of different privatisation objectives and the need to strike a balance among them. In this respect, the benefits associated with the use of this process (e.g. speed, worker support) need to be balanced against the importance of meeting other objectives

such as increased efficiency and raising revenues. In general, management and employee buy-outs tend to be most suited to smaller companies, and where the company is heavily reliant on the technical/scientific skills and judgment of its employees.

Public offerings

Privatisation through public share offerings is an open competitive process which uses the stock market. This is typically considered the most transparent privatisation method; it enhances the development of capital markets, create broad ownership, and, if successful, may help the government to build a reputation for future sales. Moreover, it is a good mechanisms to attract foreign investment, both from institutional and non-institutional investors.

The main disadvantage of this method is its cost, both because of transaction costs (technical and legal assistance) and in terms of the underpricing which is often necessary to compensate for the asymmetric information between the seller and the (potentially large number of) buyers.

Governments usually have used share issue privatisations to pursue economic and political goals like the reduction of national budget deficit (preferring secondary share offerings), the promotion of popular capitalism (setting high level of underpricing and allocating shares as widely as possible to citizens) and the growth of government popularity (setting high level of underpricing in order to guarantee high capital gains for investors) Moreover, pursuing other objectives through the privatisation becomes more difficult with such a transparent procedure.

Governments involved in privatising an enterprise through an initial public offering must face a number of decisions:

- the reorganisation of the SOE;
- the choice of the advisors;
- how much of the company to sell eventually;
- whether to sell in batches or not;
- whether to retain a golden share:
- how to allocate the shares to different classes of investors such as retail, institutional, foreign and residents;
- the price of the shares.

In particular, when a company is too large to be sold at one time, the government can benefit from selling it gradually through multiple *tranches* over a period of time. If a government takes this path, then, it must determine how large a fraction of the company's shares to issue in the initial versus subsequent offers. From a financial perspective this choice depends on the market conditions and its absorptive capacity and on the political and economic goals that the government wants to achieve. First, governments can find it necessary to retain a large stake in partially privatised companies (in particular, regulated utilities) in order to convince investors that they will not attempt to expropriate shareholder wealth. Moreover, governments often feel compelled to retain a stake in industries considered "strategic", possibly in order to prevent a takeover by foreign investors. To this end a share endowed with special powers (a "golden share") is sometimes retained – although this practice is often criticised especially within the EU, as it appears to distort the functioning of capital markets.

Through preferential allocations, officials can try to achieve political goals. In the majority of the initial offers, some fractions of the total offering are sold to employees, and these are often sold with favourable terms such as discounted prices and lenient payment schedules. In the initial offering, there are usually additional preferential allocations to individuals versus institutional investors and to domestic rather than foreign investors. Moreover, employees are effectively almost guaranteed their allocation if the offer is oversubscribed. The fact that (underpriced) shares are usually preferentially allocated to employees and to private investors suggests that governments try to build political support by targeting median-class voters, rather than maximising issues proceeds.

Mixed sales

Mixed sales – whereby some shares are sold through a SIP and others through a private sale – allow governments to combine the benefits of a private sale with the advantages of a public flotation. This method usually entails the direct sale of the control to a (group of) investor(s), either through a negotiation or a competitive bidding, accompanied by a public offering as a second stage. The public offering of the shares allows governments to promote capital market development, while the direct sale ensures that the privatised company benefits from an infusion of technology and stronger governance structures than would be the case under a

more dispersed share holding structure⁴. A third possible component is the placement of some portion of shares with the company employees, as a means of ensuring worker participation.

This combination of methods has proven successful mainly for several reasons: it has a positive impact on the domestic capital markets; it assures that the control goes to investors with the potential to make the firm profitable under a competitive environment; it allows the selected investors to restructure the company in accordance to their strategic decisions; it can also give governments the opportunity to benefit from a potential higher sale price in a second tranche. In fact, the reputation of the group acquiring control in the first stage may affect the success of the public offering during the second stage. Provisions in terms of quality and investment requirements can also be established in the contract of the direct sale and this increases the public policy options as compared to a pure public offering. The main disadvantage of this method is, again, cost. While it is true that certain common costs associated with the first and second stages can make the mixed sale's costs lower than the simple addition of the costs of a partial direct sale and a partial public offering, it is also true that a mixed sale can be very expensive and it is certainly more expensive than a pure total private sale or a pure total share issue privatisation used separately.

The success of this method depends on some circumstances: the existence of a well-developed local capital market in order to maximise the benefits of the sale and to create local broad ownership and; the size of the firm to be privatised, which has to be big enough to justify the costs of the transaction and the government's ability to ensure that good corporate governance practices are in place to protect minority shareholders. In the absence of such practices, in fact, shareholders might

⁴ The fact that telecommunications companies have been privatised using this scheme is not sheer coincidence. Sectors in need of investment for technological innovation and expansion require the controlling group to have complete decision power for a certain period of time.

be abused by the controllers and, as a result, public offerings will lose credibility with damaging effects on capital market development.

Finally, it must be noted that, even if governments plan to carry out either phase that made up this privatisation method, there is the possibility that after the private sale they can decide to not start the public offering both when the first phase is successful or unsuccessful. In fact, if the privatised company is doing well after the first *tranche* is sold to strategic investors, these investors may pressure the government for a large share or the government itself may be tempted to keep its shares. At the same time, if the privatised company is not doing well, governments may decide to postpone the second phase for fear that the public offering would fail. Mixed sales, therefore, may delay total privatisations.

5 CONCLUSION: BEYOND PRIVATISATION

The great privatisation wave of the Eighties and the Nineties seems to have slowed down first, and then stopped. In part, this is a physiological consequence of the sale of the most likely candidates to privatisation. In part, our research has pointed out that even after "some" privatisation rarely the State totally withdraws from ownership and even less from control.

What has changed quite significantly is the way the State (and more in general the public sector) intervenes in firms.

The frontier that separates public and private is more and more blurred. On the one hand, at least in SGIs privatisation (of utility sectors) entails regulation which sometimes follows international best practices, but often appears to be more extensive than it would probably be desirable. Moreover, privatised companies often remain under particular scrutiny by politicians, which seem to believe that the management of the company after privatisation remains to some extent (at least in the eye of the public opinion) their responsibility. In this sense, only after several years from privatisation do these companies become "normal".

Moreover, the boundary between private and public often takes place "within" firms. According to recent estimates, European governments own shareholdings in (listed) privatised companies worth approximately €250bn. If we add to this figure other financial holdings and the value of non corporatised assets, a conservative estimate of State property in the EU approaches €1trn. Partial privatisations are not simply a transitory phenomenon of a process which takes place in batches, but seems now an "equilibrium" phenomenon, which will probably need a further analysis in the future. This is particularly interesting in infrastructural sectors, where funding is a major issue, where often a political decision is needed to initiate the project, and where mixed forms such as PPPs are more and more common.

Finally, even if privatisation studies typically group together decisions of central and local public authorities, the phenomenon of "municipal" capitalism is still extremely relevant. Even when the State seems to withdraw from firms, local communities seem to be more reluctant to do the same. Again, the future research agenda is far from empty.

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