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Privatization Reality Check: Distributional Effects in Developing Countries

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Privatization has not been a popular reform. Economic assessments of its effects on economic welfare and growth in developing and transition economies have generally been positive. At the same time, allegations of political chicanery and corruption in Russia and Malaysia, fiscal mismanagement in Brazil, escalating prices in Argentina, and loss of jobs in numerous countries have sullied privatization's reputation, even among proponents of the liberalization of the last two decades. Thus, Nobel laureate Joseph Stiglitz campaigns for slower and more deliberate privatization, while critics of the larger liberalizing agenda—known as the Washington Consensus—conclude that privatization should be entirely opposed.

At the heart of much of the criticism is the belief that privatization has been unfair—hurting the poor, the disenfranchised, and beleaguered workers, and benefiting the privileged and powerful. Privatization, it is claimed, throws masses of people out of work or forces them to accept jobs with lower pay, less security, and fewer benefits; raises, too far and too fast, the prices of goods and services sold; provides opportunities to enrich the agile and corrupt; and generally makes the rich richer and the poor poorer.[1]

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1. A more technical critique of privatization attributes perceived efficiency and performance benefits to market reform and the enhancement of competition, not ownership change. For example, Tandon (1995, 229–30) argues: ". . . there are, of course, many cases where privatization appears to have 'resulted' in efficiency improvement; in most of these cases, however, the privatization appears to have been contemporaneous with deregulation or other types of competition-enhancing measures."

A major complaint is that, even if privatization contributes to improved efficiency and financial performance, as some contest, it negatively affects distribution of wealth, income, and political power. This perception is widespread and growing: 63 percent of people surveyed in the spring of 2001 in 17 countries of Latin America disagreed or strongly disagreed with the statement: "The privatization of State companies has been beneficial. . . ." The extent of disagreement was 6 percent higher than in 2000 and 20 percent higher than in 1998.[2] More than 60 percent of Sri Lankans interviewed in 2000 opposed the privatization of remaining state-owned firms. Similar expressions of popular dissatisfaction with privatization, of equal or greater magnitude, were found in transition countries generally and Russia in particular.

Some popular perceptions and critical assertions are accurate—mistakes have been made; promises have been broken; however, others are inaccurate. One can argue that the concrete outcomes of privatization have, in many cases, been better than people think or that privatization may not be the true cause of the problems people encounter. Nonetheless, perceptions count greatly if they result in political opposition sufficient to slow, halt, or reverse a process that would bring efficiency and growth gains to a society—gains that could, in principle, be fairly shared using tax or other policy instruments.

Moreover, the distributional effects of privatization matter because inequality matters in at least three ways:

- Most societies possess and exercise implicit limits on their tolerance for inequality, independent of its effects on growth and efficiency.
- Mounting evidence suggests that inequality can and does hinder growth, particularly in developing economies where institutions and markets are weak.[3]

2. Latinbarometer conducted interviews in April and May (2001), and survey results were presented in August of the same year; see Latinbarometer (2001). Results showed that negative perceptions about privatization had increased greatly in certain countries (e.g., Argentina, Brazil, and Colombia) and slightly in others (e.g., Chile, Ecuador, and Venezuela); however, in all 17 countries surveyed, the percentage had grown. For a general discussion of dissatisfaction with liberalizing economic reform in Latin America, see Lora and Panizza (2002).

3. Aghion, Caroli, and Garcia-Penalosa (1999) discuss the growing theoretical and empirical literature regarding this point. Barro (2000) finds that the inequality effect on growth is negative only in developing countries—a finding consistent with the likelihood that the effect operates where markets and institutions are weak and government policy either reinforces or fails to offset those factors; Easterly (2002) and Birdsall and Londoño (1997) emphasize the relevance of asset distribution.

- Increasingly, it is evident that inequality can perpetuate itself by affecting the nature and pace of economic policy and locking in unproductive political arrangements.[4]

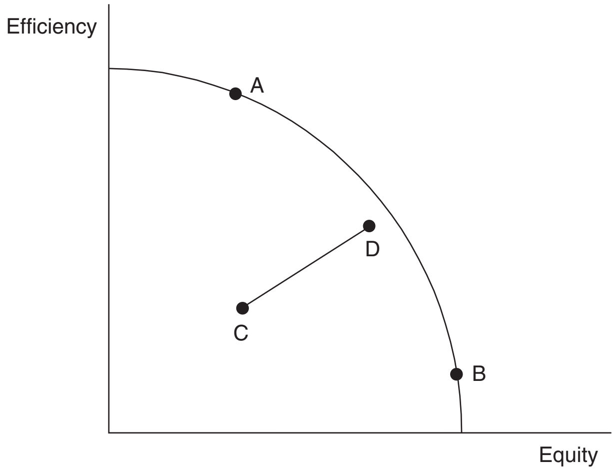
This book presents a set of country and analytical studies on the distributional effects of privatization programs in developing and transition economies. The cases cover privatization programs in Latin America (Argentina, Bolivia, Brazil, Mexico, Nicaragua, and Peru) and an eclectic set of non-Latin American countries: China, Russia, Sri Lanka, and Ukraine. We examine a relatively understudied issue and derive lessons for minimizing any trade-offs between the efficiency and equity outcomes of the process or (as we hypothesize is also possible) maximizing any complementarities. Reynolds (1985) points out that, as an economist, one cannot pretend to make any value judgment about the right trade-off between efficiency and equity outcomes. However, one can attempt to assess the nature of any trade-off or complementarity to enlighten the public debate about policy and program decisions ultimately made in the political arena.

During the 1980s and 1990s, a wave of privatizations swept across the developing world. Including the many enterprises either partially or fully privatized in the transition economies, the number of divested firms now exceeds 100,000; the total value of assets transferred has been enormous, particularly in Latin America, East Asia, and the transition region (less so in South Asia, the Middle East, and sub-Saharan Africa). Despite the massive shift to private ownership, a surprising number of firms and assets remain in state hands, particularly in China and Vietnam, but also in India, and the African and transition countries, where many large, high-value infrastructure firms have not yet been sold. Thus, information on how to conduct privatization in an appropriate, acceptable manner is still of great value.

Below, we outline a simple framework within which to consider the efficiency and equity gains and losses of privatization. The framework provides a means of thinking about the effects of privatization at the economywide level (of course, it is also possible to assess privatization's effects at the firm and sectoral levels, which many other chapters in this book do). In that context, efficiency refers to the extent to which an economy maximizes output, given inputs of labor and human and physical capital; while equity refers to the extent to which the resulting output is distributed among the population or would be distributed were there equal opportunity (e.g., across households, independent of their income, ethnicity,

4. As Hellman, Jones, and Kaufman (2000) documented in the Russian case, initial distribution of resources and property rights to a limited set of actors, in a situation with few institutional impediments to translating economic power into political power, created a group able to block subsequent competition-enhancing and redistributive reforms. Nellis (1999) offers a similar argument.

Figure 1.1 Equity and efficiency: Competitive versus imperfect market



and gender composition).[5] Following their outline of the general framework, we summarize literature on privatization's overall efficiency effects; these are most commonly considered at the firm level, in terms of changes in performance post-sale, gains or losses to aggregate welfare, and competitiveness and prospects for economic growth. The summary of evidence on efficiency effects at the firm level provides useful and necessary background to any assessment of privatization's likely effects on equity at the economywide level. Using the general framework, we then reflect on what is known from theory and existing studies on distributional issues, with special emphasis on this book's case studies and analyses. These findings provide the basis for our conclusions about the distributional effects of the recent wave of privatizations in developing and transition economies.

General Framework

Economists usually frame the question of equity or distribution within the context of a trade-off with efficiency or growth. At the production frontier of a perfectly competitive economy, without any externalities, information asymmetries, or other problems of missing or imperfect markets, such a trade-off is likely (figure 1.1).

5. Thus, equity refers not to the distribution of income as an outcome, but to the distribution of opportunity—the latter allowing for differences in motivation, work habits, and other characteristics across individuals that are, in principle, independent of social or economic standing in a society, as well as race, gender, and ethnicity.

At that production frontier, the only efficient means of redistribution is through lump-sum transfers that have no effect on the incentives of economic agents or prices. An efficient economy can be highly inequitable (point A) or equitable (point B), often as a function of some initial allocation of assets (e.g., financial, physical, or human capital) that generate income. Any move along the frontier will lead to either more efficiency and less equity or vice versa, the definition of a trade-off.

In an imperfectly competitive economy, however, such a trade-off is not a necessity. At point C, the economy could potentially move toward both greater efficiency and equity (e.g., to point D).[6] Most developing and transition economies are less efficient than those of industrialized countries. Their low incomes result not only from limited resources; they often fail to use their resources well because of a lack of enforceable property rights, policy failures (e.g., highly distortionary tax systems and labor market rigidities), outright corruption, and protected monopolies that state enterprises often represent.[7] Historical injustices, civil conflict, political instability, crushing levels of disease, and frequent natural disasters may also play their role in keeping economies more or less permanently inside the efficiency frontier.

For any given productive capacity, many of these economies are also highly inequitable—either because of government or policy failures that sustain insider privileges, or corruption or historically driven concentrations of wealth in land, oil, or other assets. Of course, a society could also be inefficient and equitable, such as Cuba, or highly efficient but also relatively inequitable, such as the United States (figure 1.2).

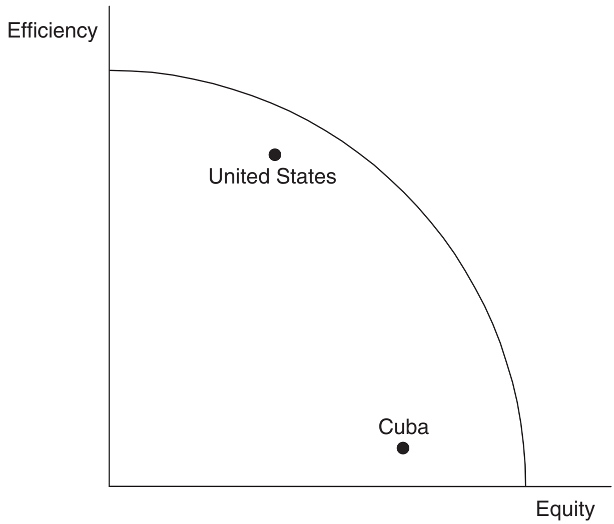
In most developing and transition economies well inside the production frontier, there is no *necessary* trade-off between increased efficiency and resulting economic growth on the one hand, and increasing equity on the other; thus, it should be possible to implement privatization transactions (firm by firm) in ways that promote both equity and efficiency. For example, to the extent that privatization reduces monopoly rents held by the wealthy, it is likely to increase both efficiency and equity in the overall economy.[8]

6. Birdsall, Ross, and Sabot (1995) argue that lack of trade-off explains why several East Asian countries, with relatively low inequality, grew rapidly from the 1960s through the 1980s, compared to Latin American countries, with their high inequality; see Alfaro, Bradford, and Briscoe (1998) on privatization's effects on the water sector and James (1998) on partial privatization of pension systems.

7. Thus, as Easterly (2001) notes with compelling examples, using foreign aid to provide additional investment capital or foreign exchange will not necessarily yield additional product or growth.

8. For the theoretical underpinnings of this view, see Aghion, Caroli, and Garcia-Penalosa (1999) and Benabou (1996); for empirical refinements, see Barro (2000) and Birdsall, Ross, and Sabot (1995).

Figure 1.2 Relative efficiency and equity of US and Cuban economies



The structure and outcome of each privatization event comprise only one factor in the overall story of privatization's effect on equity (or distribution) at the country level. Conditions before privatization matter—the more inequitable the initial situation, the greater the scope for improvement in equity. The same is true with respect to initial inefficiency (figure 1.3). The environment following privatization—degree of competition and regulatory arrangements—can and often does reinforce or alter the preprivatization path.

Complicating matters further, the one-time privatization event—even if extended over several years—may help determine the postprivatization policy and institutional environment, and thus a society's long-term path. For example, mass privatization efforts in transition economies were justified on the grounds that privatization was necessary—perhaps even sufficient—to create competition and induce increased firm (and overall economic) efficiency. (In figure 1.4, one would move from point A to point B via privatization and then from point B to point C in the competitive environment after privatization). However, the unanticipated outcome in several countries, most notably Russia, was that the event initially increased the economy's inefficiency, but also locked in insider privileges (moving from point A to point D); those insider privileges included competition-eroding corruption, which undermined efficiency (Stiglitz 1999a, b).

Because the postprivatization path of distribution in a society is neither unidirectional nor necessarily fully determined by transfer of ownership, any single snapshot assessment of where a society is, relative to where it

Figure 1.3 Privatization with relatively more efficiency (a) or equity (b)

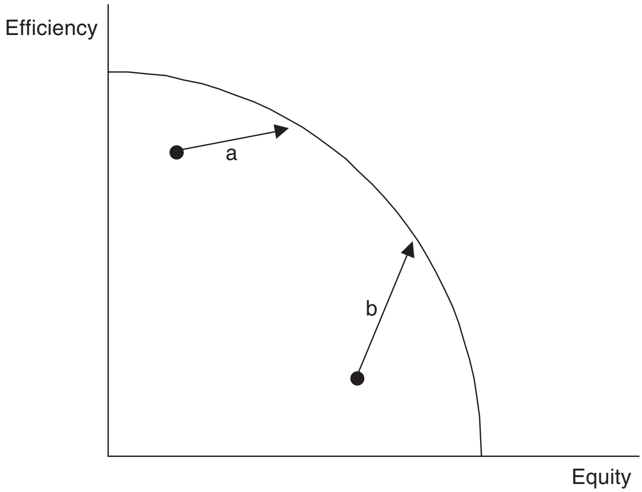
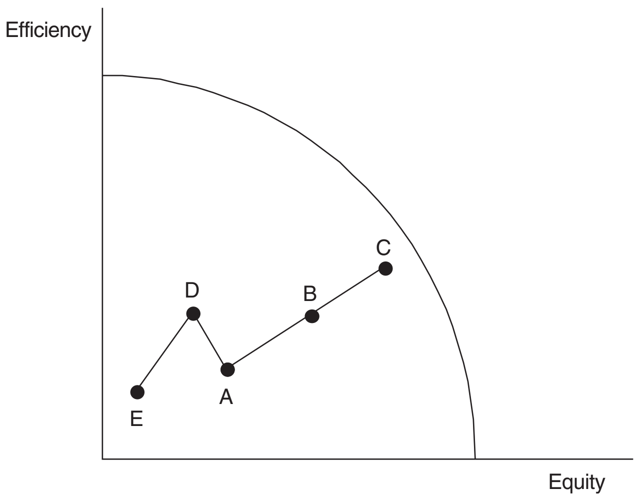


Figure 1.4 Potential postprivatization paths



was, may be a poor indicator of privatization's long-term effects. The outcome will be shaped by the amount of time passed since the process began, the extent to which the process affected the environment following privatization, and a host of independent factors after privatization that can affect the direction of the path (e.g., the efficiency gain at point D was temporary).

We take it for granted that the central objective of privatization in developing and transition economies, as well as in industrialized economies, is to secure efficiency gains for the economy as a whole (although some in the transition region have interpreted privatization as a primarily political act, required to sever links between the state and productive enterprises). Where distributional issues have been considered, they have generally been devised within the context of smoothing out the process to make it politically more palatable (e.g., when employees of enterprises to be privatized are given special deals on obtaining shares in the new firm, or when sellers oblige new owners to accept postprivatization conditions, such as service guarantees for less profitable markets, commit to certain levels of investment, or maintain employee numbers for a specified time). The distinction between a general distributional goal and a technique to obtain support is not always clear. For example, the voucher programs of Eastern Europe and Russia and Bolivia's capitalization program aimed ostensibly at adequate distribution of the "patrimony," although they also were designed to mute political opposition to reform.

Behind the usually paramount goal of improving efficiency has been the implicit assumption that government could and should use more traditional, direct instruments for redistribution, through tax and expenditure policies. Of course, that assumption may not always have been borne out because of political and economic constraints independent of privatization per se. That raises the normative question: Should privatization be exploited as a more direct and less costly opportunity for redistribution or should the likelihood of the process exacerbating inequality at least be minimized?

Some familiar examples illustrate the logic of the framework (we do not claim that these vignettes are absolutely accurate in all details). With its highly planned economy, the former Soviet Union was initially inefficient, though reasonably equitable, because everyone was comparably badly off (figure 1.5, point A). Privatization in Russia may well have made the economy simultaneously more efficient and more inequitable, as some former state assets were acquired by a relatively small group of insiders (path a). The resulting concentration could further worsen equity and stall, or even reverse, efficiency gains as new insiders concentrate on asset stripping rather than productivity-enhancing investments (path b). However, subsequent policy shifts, including a start on controlling corruption, could bring increased equity (by eliminating favors) and efficiency (as the elimination of implicit insider subsidies yields a more competitive environment [path c]).

In Peru, a state-run electricity utility could be inefficient initially, with poor management, high technical losses, poor revenue collection, and irrational pricing. It could also contribute to inequality, providing virtually no services (in effect, services at an infinite price) to poor neighborhoods, while underpricing or failing to charge and collect fees from middle-class and wealthy neighborhoods or large industrial users (figure 1.6, point A). Privatization could increase efficiency dramatically at the enterprise level

Figure 1.5 Efficiency and equity gains and losses: Former Soviet Union and Russia

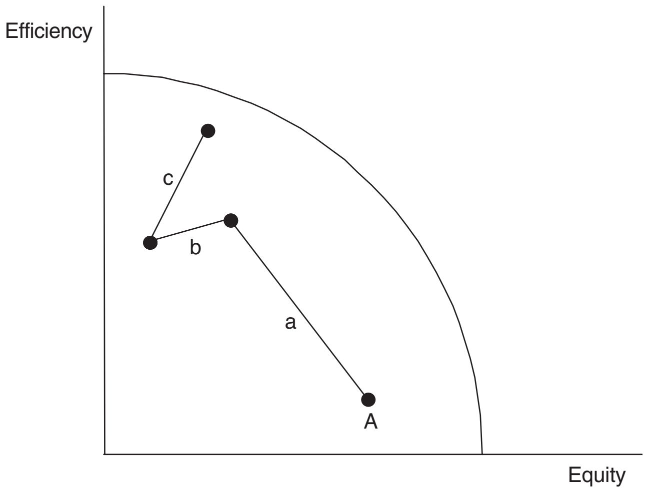
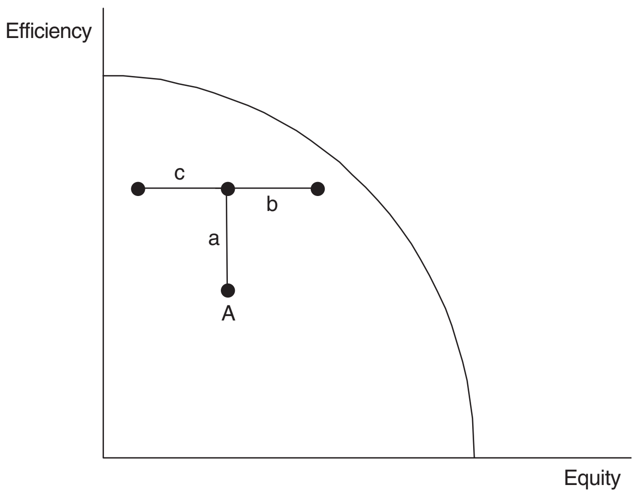


Figure 1.6 Efficiency and equity gains and losses: Peru's electricity sector



via technical-efficiency gains and, at the economywide level, by stemming the hemorrhage of publicly financed subsidies, thereby promoting responsible fiscal management.

It is easy to imagine offsetting the effects on overall equity (path a); they could result from a combination of higher prices for the previously insulated middle class, with improved access (and a lower than "infinite" price) for the poor. Some of the poor (e.g., those in rural areas) would remain unserved and thus relatively worse off than other poor, though not in any absolute sense. The urban poor—those whose prior access through illegal hookups was eliminated, a common outcome of electricity privatization in Latin America and Asia—might be absolutely worse off as well. In subsequent years, equity gains could be reinforced or reversed, depending on political pressures and regulatory capacity in an institutional and technical sense (paths b and c).

In the United Kingdom, privatization of the electricity sector may provide large efficiency gains initially; however, nonaggressive or incomplete regulation in the years immediately after a sale may mean that the new owners, not consumers, will capture most of the initial gains (figure 1.7, path a). Moreover, if this or any other privatization results in layoffs of relatively low-skilled, low-paid workers, the wage gap between skilled and unskilled workers will likely increase as the supply of the latter in the larger market increases.

In Brazil, privatization of state telecommunications monopolies may bring huge efficiency gains, with greatly increased coverage, access, and quality for consumers and productive sectors for which communications is a critical input. However, underpricing of the firm to ensure successful sale may mean that middle-income taxpayers lose out and that windfall gains to a few new owners increase overall concentration of assets (figure 1.8, path a).[9] If those windfall gains go primarily to foreigners, the domestic distribution of wealth and income may not be affected directly; however, they may spawn a sense of unfairness in the society as a whole. Selling governments could squander the fiscal windfall because it temporarily relieves the budget constraint on acquiring more debt. This could lead to subsequent increases in interest rates or reductions in social and other expenditures that are relatively progressive; these second-stage, indirect effects could exacerbate the initial inequity (path b) (Macedo 2000).

The above framework and simplified examples illustrate that the distributional effects of privatization cannot be easily predicted. The effects on equity depend on at least three factors: initial conditions, sale event, and the postprivatization political and economic environment. The privatization event may reinforce or undermine aspects of the environment that are conducive to equity, may simply reflect that environment, or may be independent of it. Judging those effects may also depend on the point along the path at which one measures the outcome. In the end, the question is empirical, unlikely to yield to any simple generalization across countries and over

9. Governments often underprice firms sold through share issues to ensure the sale will go forward. Failure to meet the reserve price is an embarrassment; thus, major purchasers get a bargain. However, another reason for underpricing is to encourage local, first-time small investors to participate. Paradoxically, a mechanism devised with at least some distributional purpose may add to overall inequity.

Figure 1.7 Efficiency and equity gains and losses: United Kingdom's electricity sector

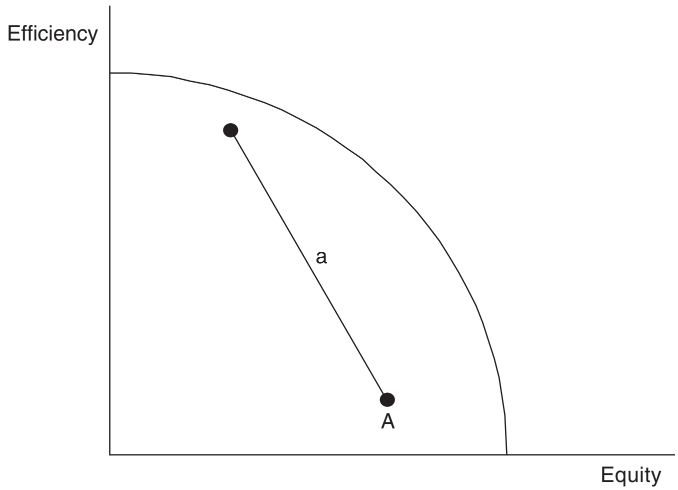
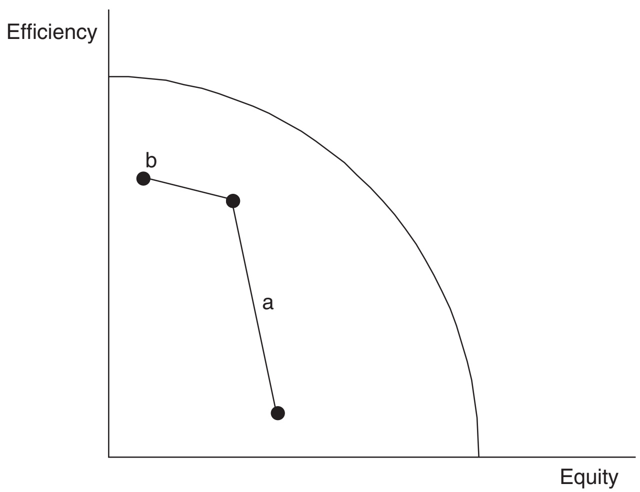


Figure 1.8 Efficiency and equity gains and losses: Brazil's telecommunications sector



time. Thus, understanding the distributional effects of privatization requires assessing real cases and couching those cases in the larger context of their political, economic, and historical environment—precisely the approach undertaken in this book.

At the same time, our framework reflects the view that, in most settings, particularly in nonindustrialized countries, efficiency-enhancing privatization has also left room for equity enhancement. If a trade-off has occurred, it might have been avoided or diminished by an alternative process or earlier, more vigorous attention paid to constructing a different environment after privatization (regarding competition, regulation, and other factors).

Overall Economic Record

On the whole, privatization has proven its economic worth. The shift to private ownership, with few exceptions, has improved firm performance. This finding has held true in most countries, including poor ones and former socialist economies in the transition region. After privatization, profitability has generally increased, often substantially, as have output, dividends, and investment. In their extensive literature review, covering 65 empirical studies at the firm level, and in firms within and across countries, Megginson and Netter (2001, 380) conclude that "privately-owned firms are more efficient and more profitable than otherwise comparable, state-owned firms."[10]

Privatization's economywide effects on the government budget and on growth, employment, and investment are less solidly established. The most elaborate study to date, a review of 18 privatizing countries (Davis et al. 2000), reported substantial gross receipts from privatization, accounting for nearly 2 percent of annual GDP. Governments have generally ended up with about half that amount, reflecting the high costs of clean-ups and sales. Even 1 percent of GDP is substantial; however, the long-run fiscal effects on government revenue generally come not from sales proceeds (resulting from a one-time sale of an asset), but from elimination of preprivatization subsidies to state enterprises and subsequent increased tax revenues from more profitable and productive private enterprises.

Such governments as Ivory Coast, Mexico, and Mozambique received, in the first few years following sales, more from privatized firms in taxes than from direct proceeds of sales. In Bolivia, for example, a flow-of-funds analysis shows a US$429 million return to government in the first four years following sales, despite the fact that the government did not receive any sales proceeds.[11] In addition, Davis et al. (2000) conclude that markets and investors regard privatization as a positive signal of the political likelihood

10. The studies range from single-firm case studies to assessments of various privatizations in a single country (e.g., 218 in Mexico) to surveys of all available literature on an entire set of countries (e.g., review of the results of privatization in 26 transition economies).

11. The Bolivians capitalized a group of the largest state firms by selling 50 percent of equity to strategic investors, who committed to investing the total sales price into the firms. For details, see Barja, McKenzie, and Urquiola (chapter 4, this volume).

that a government will stick with its overall reform program, implying somewhat higher investment rates in the economy overall.

This is not to say that privatization always works well everywhere. Studies on the effects of privatization are more numerous in data-rich, industrialized and middle-income economies than in low-income countries. In the latter, privatization has proven more difficult to launch, and less likely to generate quick, positive effects. In certain settings—Armenia and Moldova, for example—privatization has not yielded visible performance improvements. Even in countries where the process has succeeded overall, not every privatization improves firm performance. In three comparable studies examining 204 privatizations in 41 countries, 20 to 33 percent of privatized firms registered slight or no improvement, or, in some cases, worsening situations (Megginson and Netter 2001, 355–56). While a success rate of 66 percent to 80 percent is good, inherited conditions place some firms beyond hope of internal reform even with new owners because markets and policy frameworks are too poor for ownership change alone to turn the tide.

Partly because it is not a panacea, controversy continues about the effects—and thus the desirability—of privatization, particularly in countries where complementary reforms are not in place, competition is limited, and regulatory and supervisory capacity are embryonic. These country conditions are especially relevant for natural monopolies and in such sectors as banking. Nonetheless, evidence shows that privatization has been among the more successful of liberalizing reforms; that is, in many more cases than not, it has yielded good returns to new private owners, freed the state of a heavy administrative and unproductive financial burden, provided governments with a one-time fiscal boost, and helped sustain a larger process of market-enhancing economic reforms.

These results are encouraging—if not surprising—since most developing countries and transition economies are well inside the optimal production frontier. Because of policy distortions and government failures, there is often ample room for increasing efficiency by reducing the state's stranglehold on resources and making room for competition that fosters individual entrepreneurship, motivates workers, and supports overall productivity gains.

We emphasize this broad conclusion about the efficiency effects of privatization, in part, to stress that assessing the distributional question does not imply an attack on privatization per se, even—or especially in—welfare terms. In certain cases, privatization has produced both increased income and wealth for all citizens, while increasing inequitable distribution of that income and wealth. Thus, it usually makes no sense to forgo absolute gains for all because of an increase in relative disparities. We neither deny the need to reform grossly inefficient and financially burdensome public enterprises nor imply that deficiencies of such enterprises could somehow easily be corrected without social pain or economic cost.

Rather, these case studies suggest that, in the process of privatizing, opportunities have been missed for minimizing equity losses or maximizing equity gains. In some cases, lost opportunities have probably reduced the efficiency gains of the privatization process (e.g., by excluding potentially more competitive bidders) or long-term gains to the economy (e.g., where limiting sales to nationals has permanently locked out potential bidders). It may be that privatization's unpopularity is not only a political constraint to sustaining privatization and other efficiency-enhancing reforms, but rooted in a populist view of what is fair. It may be that there is room for a better overall deal—one that is both fairer and more efficient. Determining what has happened regarding distribution and examining the possibility that more equitable outcomes could have been produced are the principal themes of this volume's case studies.

Potential Distributional Shifts

At issue is how privatization affects household consumption and welfare across income groups. Household consumption depends on both income and prices. Income, in turn, depends on assets—labor, human capital, land ownership, and other physical or financial capital—and its return. Areas in which one might encounter distributional shifts resulting from ownership change are discussed below.

Asset Distribution

Privatization usually involves a shift from an asset owned (in theory) by taxpayers as a whole to one owned by private persons or firms. Whether the shift in ownership reduces or increases overall equity in a society depends, in part, on the extent to which the price received by the selling state adequately reflects the asset's underlying value. For example, if the seller underprices the asset to ensure a quick sale, equity will likely decline, at least in the short term. The effects of change in ownership on the long-term income distribution between taxpayers and new owners ultimately depends on both the initial price and postsale stream of value the asset produces. Privatization might be arranged to spread direct (i.e., share) ownership widely among the affected population. It may also confer, or permanently deny, hitherto unrealized pension benefits, creating or eliminating an employee asset.

Return on Assets: Labor

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

Proponents of privatization suggest that poor past performance of public firms requires a period of restructuring, including cuts in employment, a portion of which might occur before sale. However, the job-reduction phase would be temporary; under more dynamic private ownership, total employment numbers would eventually recover and even surpass the number originally employed. On the other hand, critics, particularly union leaders, allege that cost-cutting measures in preparation for sale or by new private owners fall disproportionately—and unfairly—on workers. Labor leaders argue that poor management and government policies are the major causes of the financially troubled state of public firms, while labor is asked to pay the price of reform.

Return on Assets: Physical Capital

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

Pricing and Access

Privatization can affect pricing differentially across income groups. On the one hand, prices could fall. If increased competition is part of or accompanies change of ownership, the private owner might be forced to offer lower prices. If private management is more efficient, savings might be passed on to consumers. Conversely, prices could increase if government action had previously held them below cost-covering levels; new private owners move to end illegal connections to services and collect from previously tolerated, delinquent customers; or bodies regulating privatized infrastructure firms are weak or ineffective. The distributional effects of price shifts will depend on the extent to which consumption of the goods and services in question varies by income group and whether consumption levels or consumer categories face different prices. In the case of infrastructure, it will also depend on the density and competence of regulatory bodies, which, in theory, protect consumers from the abuse of natural monopoly power.

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

Pricing and access are inextricably linked. The prices citizens and consumers face can be broadly conceived to include whether they have access to a particular good or service (e.g., the price is infinite if they lack access to electric power) and its quality (a lower quality for a given nominal price implies a higher real price). While steep price increases following privatization have been common, they have not been universal in divested network or infrastructure industries, such as electricity, water, and sewerage, and telecommunications.

On the equity side, reformers argue that protecting consumers by keeping prices of essential services artificially low failed, resulting in subsidies to the comparatively wealthy and higher costs elsewhere in the economy, which outweighed the policy's benefits. Better, it was thought, to let the firms operate under private, profit-maximizing ownership, and use other state mechanisms, such as taxes and regulation, to protect consumer welfare and acceptable levels of income distribution.

Nonetheless, one can readily point to situations where rational pricing policies, followed by private profit-maximizing ownership, could impose disproportionate costs onto lower-income groups. Again, infrastructure yields the most obvious examples.[12] Potential price increases in electricity and water—required to cover costs and expand the network—would fall more heavily on poorer consumers, who are more likely to spend a higher percentage of their income on these services than are the wealthy. New private owners' often vigorous moves to collect arrears and end illegal water and electricity connections likely fall most heavily on the poor. Even when a privatized service expands through investment into formerly unserved, and thus probably poorer, neighborhoods, residents might be unable to take advantage of it because of the high upfront costs of equipment that consumers often must provide.

In telecommunications, a common result of reform and privatization has been tariff rebalancing, leading to price increases in formerly subsidized, local fixed-line telephony, while introducing competition—usually producing rapidly falling prices—in international services and mobile phone

12. In many countries, the mass of poor are not connected to many infrastructure networks, making moot the issue of gains and losses relative to other income groups; however, recent research shows that a surprisingly high percentage of the developing world's population is connected to the electricity grid. A far smaller fraction has formal water or telephone services. See Komives, Whittington, and Wu (2001).

systems. Since the poor are likely to place most of their calls locally through fixed lines, the price increase could negatively affect distribution.

As with pricing, access or coverage issues most often arise in the context of infrastructure privatization. Because of low tariffs and other investment constraints, many publicly owned infrastructure firms persistently fail to meet demand. Infrastructure sales and concession contracts often give the purchaser exclusive rights of service provision for a period of time in return for commitments to specified levels of investments and expansion targets in order to extend service to formerly unserved clients and regions. In many cases, a disproportionate percentage of new customers is drawn from lower-income groups since they are the only ones not connected. The distributional effects of this expansion are a function of the initial income of the new customers and the relative shifts in expenditure that result from connecting to the network. For example, where the poor were paying vendors for water, network connection could result in lower unit costs if they can afford the often substantial, upfront connection fee. Moreover, they might face a minimal consumption threshold that exceeds the amount they previously consumed, thereby raising their costs and worsening distribution.

Another reason for a period of exclusive monopoly in infrastructure service is the high risk borne by investors. However, if the new private utility uses its exclusivity rights to eliminate less formal—and perhaps less expensive—service providers, then certain consumer groups, including low-income customers, may lose access to an alternative service and become worse off.

Fiscal Effects

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

Reality of Distribution: Efficiency over Equity

The empirical work of the last five or six years—some of which was commissioned for this volume—leads one to conclude that, while many, if not most, privatization programs have a stated goal of improving distributional equity and while many have built in specific measures (e.g., vouchers) to achieve this aim, most such programs to date have done more to enhance efficiency than equity. Regarding income distribution, privatization has had slight or no effect in Latin America, the best-studied region. In Russia and Sri Lanka, studies more commonly conclude that privatization has negatively affected income distribution; however, data limitations make these conclusions more speculative. The negative wealth-distribution effect appears to arise primarily from the transfer of assets to the relatively wealthy, not by reducing assets of the relatively poor. Negative income-distribution effects appear to stem primarily from price movements of privatized infrastructure products. As discussed below, the issue is complicated: In most Latin American cases, for example, the equity-enhancing effects of increased access to infrastructure services outweigh the negative effects of increased prices.

Equity consequences have varied greatly by region and country, with certain studies (e.g., Latin America) recording neutral or slightly positive distributional effects and others (e.g., Russia) postulating large negative effects. In terms of this chapter's analytical framework, the average privatization program reviewed in the literature has taken path x (figure 1.9).

Disaggregating this general conclusion is the topic of the sections below.

Ownership

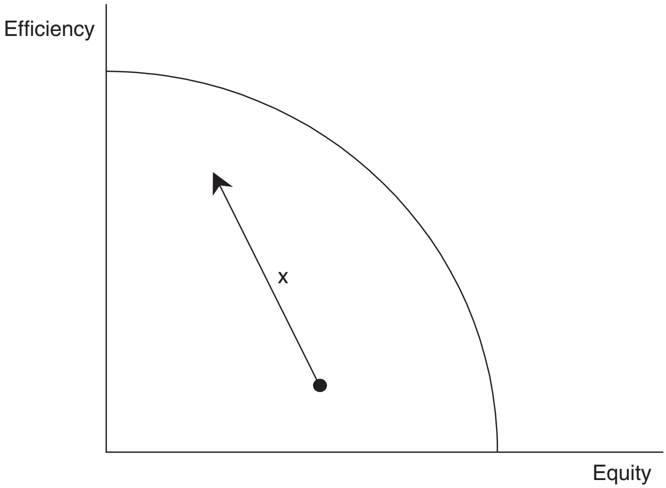
Troubling or disappointing outcomes are particularly common with regard to ownership. In many transition countries, privatization programs and techniques have often resulted in massive, rapid transfer of asset ownership from society at large to a small group of daring, unscrupulous actors. One can argue, as do Åslund (2001) and Shleifer and Treisman (2000), that, despite the admittedly unfair and often illegal manner of asset allocation, the results obtained are superior to the alternative of leaving firms in state hands; the resulting distributional loss is an unavoidable, bearable price that must be paid for the efficiency gains, and, indeed, the transition, to succeed.[13]

Others vigorously dispute this conclusion (Stiglitz 1999a, b). While few would defend the notion that socially- or state-owned enterprises were managed mainly with the public interest in mind during the pretransition period, ownership has become more concentrated, with negative, if perhaps short-term, consequences for asset distribution.

The ownership issue has caused concern in less dramatic, but more empirically determinable, circumstances. In their study on privatizing the United Kingdom's electricity sector, Newbery and Pollitt (1997) show that,

13. Åslund (2001, 21) argues that any attempt to avoid or delay privatization in transition economies would only have compounded the pain. Shleifer and Treisman (2000, 38) view the inequities of Russian privatization as troubling but better than the alternative of inaction.

Figure 1.9 Privatization's initial effects: Average-case scenario



in the first years following the sale, new private shareholders captured the bulk of financial rewards generated by substantial efficiency gains at the expense of taxpayers (caused by both insufficient introduction of competitive forces in initial transactions and weaknesses of the regulatory framework). In this case, both government and consumers reaped some gains; the contrast is not winners to losers, but rather overwhelming winners to small winners. In a subsequent study, Newbery (2001) concluded that, as time passed and electricity regulators gained experience, they became increasingly able to transform efficiency gains into lower consumer prices. As noted, how one assesses privatization outcomes depends partly on when one makes the assessment. Nonetheless, the effect of initial wealth distribution was negative in both the Russian and the British electricity cases.

Mechanisms used to address the ownership issue have included offering the general population vouchers and reserving a tranche of shares in privatized firms for employees (and sometimes retirees), usually offered at a steep discount or with an easy payment arrangement. This has proven useful in reducing employee resistance to privatization. In many cases, sharp increases in share prices post-sale have improved the income position of shareholders—including employees—although the number of people affected by such schemes has usually been too small to influence overall distribution patterns [14]

14. Employees often quickly sell shares acquired in this way; even then, however, they tend to benefit since government sellers tend to greatly underprice initial offerings.

In transition economies, vouchers have been widely disseminated; however, the distributional effects have been disappointing, not only in the infamous cases of Russia and the Czech Republic, but also in Kazakhstan, Lithuania, Moldova, Mongolia, and elsewhere. It is disappointing because recipients, who obtained the vouchers for free or at a nominal price, received much less than anticipated or promised on their returns, and much less than the wealth gained by the dishonest few. In some cases, the best companies were not privatized by vouchers but, through nontransparent deals, went to managers and their supporters. In other cases, dispersed minority shareholders (shares obtained by vouchers) found that all assets were "tunneled" out of their firm, which suddenly consisted only of liabilities; the value of minority shares fell overnight to zero (as someone gained a majority stake and had no use for more shares); the company was inexplicably unlisted from the stock exchange; or the privatization fund invested in transformed—without notice, discussion, or appeal—to an unsalable status.[15]

The major distributional problem in transition states may be more psychological than financial: People were told directly or indirectly that the voucher was the means whereby the mass of state property would be equitably shared among citizens. This did not happen—in reality, it probably never could or even should have happened—and the disappointment and resentment engendered by this failure is still discernible and of political import in Russia, the Czech Republic, and most countries of the former Soviet Union.

At the same time, the generally positive distributional outcomes observed in a few cases (see chapter 4, for example) suggest that negative paths are not an automatic or inevitable result of applying privatization. The initial Bolivian program, for example, appears to have promoted both efficiency and equity (figure 1.1, moving from point C to point D) partly because of political foresight and clever program design and partly because the prevailing stable macroeconomic situation—itself a function of wise leadership—allowed the implementers substantial financial latitude. (The Bolivian public's perception of the program, nonetheless, remains negative.) The point, for the moment, is not the extent to or the frequency with which equity-enhancing outcomes occur; it is that they occur at all.

Employment

In terms of returns on assets (other than shares of firms), a pressing question has been the effect of privatization on employment levels and returns

15. John Williamson suggests that, in Russia just before price liberalization, an alternative to vouchers might have been converting excess money balances of households into bonds. Households could then have used the bonds to bid for enterprises being sold. This might have avoided the inflation that, inter alia, wiped out the savings of thrifty Russians and transferred enterprises to a group more likely to hold shares and able to take measures to defend their interests. (Personal communication with the authors.)

to labor. Despite the saliency of the employment issue, the matter has only recently been rigorously studied. What is clear is that public enterprises were overstaffed, often severely so. Moreover, in preparing, or as a substitute, for privatization, public enterprise employment numbers have declined, sometimes greatly; these declines have generally continued after privatization. A survey of 308 privatized firms in developing countries shows postsale employment reductions in 78.4 percent of cases, with no change or job gains in the rest (Chong and López-de-Silanes 2002, 43). On the other hand, a review of 81 privatizations in the Ivory Coast (before the recent troubles) found that employment grew faster in privatized firms than it had in state firms before privatization. Many Ivorian firms operated in competitive markets, and their output and overall performance improved with privatization (Jones, Jammal, and Gokgur 1998).

The question of what types of jobs people find after dismissal from public enterprises is just beginning to receive attention; however, fragmentary evidence suggests a lengthening of hours worked and reduced fringe benefits and security of tenure.

Worldwide, more people have lost, rather than have gained, jobs through privatization over the short term. However, calculating the overall distributional effects of these losses is difficult. Few studies provide detailed information about the incidence and size of severance payments or the amount of time required to find alternative employment[16] (or even whether those dismissed derived most of their income from employment, although this is probably a reasonable assumption).

Recently, more rigorous attempts have refined the knowledge of privatization's effects on labor. In Ukraine and Sri Lanka (see chapters 10 and 12, respectively), Mexico (La Porta and López-de-Silanes 1999), and several other countries studied, salary levels have generally risen (sometimes greatly) for those retained by the new private entities. Interestingly, this is not the case in China (see chapter 11).

In summarizing evidence from Latin America, McKenzie and Mookherjee (chapter 2) calculate that the net effects of privatization on overall unemployment in that region were minimal. They argue that the numbers dismissed were small in relation to total work forces and that, during the peak privatization period of the early 1990s, private-sector expansion rapidly absorbed most of those laid off because of divestitures. Similarly, Knight-John and Wasantha Athukorala (chapter 12) shows that the net number of layoffs in eight major privatized firms in Sri Lanka amounted to 5,400, a small fraction of the country's labor force. Large overall increases in

16. Galal et al. (1994) attempted to estimate gains and losses to employees for the 12 privatizations they reviewed. They concluded that no worker lost out as a result of privatization because the average severance package received was greater than the average wage lost during the average period of time a worker was unemployed before finding another job.

unemployment in Latin America, Sri Lanka, and other settings are troubling; but they came later and were caused, not by privatization, but by external shocks, labor-market rigidities, and lack of financial discipline. It has even been argued that privatization may have mitigated unemployment; that is, without privatization, unemployment levels would be higher (Behrman, Birdsall, and Szekely 2000).

Despite arguments that privatization has contributed little, if at all, to rising unemployment, the public is persuaded, in Latin America and elsewhere, that the distributional effects of privatization through employment are large and negative.

Prices and Access

A widespread result of utility privatization is network expansion and increased access to services by the population, especially the urban poor (the rural poor remain generally excluded). Expanded access can be seen in Argentina, Bolivia, Mexico, Nicaragua, Peru, and other Latin American countries (see other chapters in this volume, including the summary discussion in chapter 2).[17] Increased access is often large; the rate of increase typically far exceeds that of the predivestiture period, and the Latin America studies mostly conclude that poorer segments of the population have benefited disproportionately from these increases.

Expansion is partly a function of profit-oriented owners moving to expand their markets—easier now that the firm can tap private investment capital—and partly a matter of sales contracts stipulating investment and network expansion targets. In the few cases where access increases significantly and prices do not rise greatly (e.g., Bolivia, except in one water concession where prices jumped), hikes in access rates appear sufficient to increase equity.

Often, however, increased access is accompanied by higher prices. Various studies reveal that the amount and structure of such price increases[18]—caused, in part, by the common need for privatized firms to raise their retail prices to cost-covering levels and, in part, because inexperienced regulators have found it difficult to hold down or reduce tariffs in privatized infrastructure firms—increase short-term inequity (e.g., Argentina, Peru, and Spain [Arocena 2001]).[19] The finding is sufficiently generalized to prompt

17. Earlier studies show similar results (e.g., Torero and Pasco-Font 2001, Delfino and Casarin 2001, Paredes 2001, and Barja and Urquiola 2001).

18. This connection appears easy to determine; however, various studies reach different conclusions, depending on the years of comparison and other factors. In the case of Argentina, for example, Delfino and Casarin (2001) assert large price increases after privatization; Ennis and Pinto (chapter 5) state that prices for the privatized utility services declined significantly.

19. As with employment, the counterfactual is imperfectly known; failure to privatize might well have hurt the relatively poor even more through fiscal effects (e.g., regressive overall taxes) or inflation.

Estache, Foster, and Wodon (2002, 9), in their review of infrastructure privatization, to conclude: "One of the most painful lessons is that, unless governments take specific actions, the gains from reform take longer to reach the real poor than the richer segments of the population, and hence worsen income distribution."[20]

An important part of the price effects stems from eliminating illegal connections to electricity and water networks. Delfino and Casarin (2001, 23) note that in Argentina, for example, 436,000 of the first 481,000 additional subscribers to the privatized electricity system were those who formerly had illegal hook-ups. Assuming that most of those subscribers were lower-income people, the result is likely increased inequality in income distribution.

Fiscal Effects

Finally, in studies covering 18 mostly developing and transition countries, the net fiscal effects of privatization amounted to about 1 percent of GDP, a substantial amount for a single year; however, it is a one-time gain that is modest relative to the size of economies or even of government budgets over several years. In certain countries, the critical fiscal benefit of privatization has been to eliminate direct budget transfers (which subsidized commercially unviable enterprises or compensated politically determined underpricing of an enterprise's services or products). That subsidy flow was particularly great for politically visible, public infrastructure services (e.g., energy utilities, railroads, and telecommunications). This usually led to rationing or underpricing of services and penalizing lower-income households that lacked access. Tax-financed subsidies provided benefits primarily to the nonpoor, in the form of employment at above-market wages or underpricing for those with access. Neither helped—and both may have harmed—equity.

Many developing countries have regressive tax systems that rely heavily on indirect trade and value-added (consumption) taxes. To the extent that privatization reduces the hemorrhaging of funds in order to keep losing firms afloat, it produces indirect benefits in terms of increased, retained tax revenues. In addition, more efficiently managed, higher productivity private firms tend to pay more taxes, thus increasing government revenue. All of this could result in increased benefits to the relatively poor; that is, because expenditure patterns in most developing countries are more progressive than income distribution, this might benefit the relatively poor indirectly. The critical question of whether this actually occurs has been neglected. Several cases in this volume examine state spending patterns on health and education during the privatization period; however, the findings are mainly preliminary and speculative.

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

In many cases, governments have used revenue from privatization to reduce the stock of public debt, which, prima facie, makes sense. However, the ultimate use of privatization revenue is a function of a government's overall fiscal performance since, even when revenue reduces debt stock, indiscipline on the fiscal side means the revenue indirectly finances the government's current expenditure or increases its space to borrow more. Macedo (see chapter 7, and 2000) indicates the likelihood that privatization revenue in the mid-1990s merely prolonged the period during which Brazil tried to sustain the nominal value of its overvalued currency and put off the day of reckoning, which finally occurred in 1998. Thus, potential fiscal benefits were lost as government used reserves to protect the currency. In the case of Argentina, Mussa (2002) refers to the same failing. Revenue from privatization in the mid-1990s was significant over a period of three or four years. Despite this infusion, the government failed to generate the required fiscal surplus. Both national and subnational governments continued borrowing, and ultimately, privatization revenue was swallowed up in the collapse of the currency and debt default in 2002. In Bolivia, the initial situation seemed better because its government did not accept sales revenue; in effect, it retained one-half the value of the enterprises (as shares held to generate benefits for future pensioners) and exchanged the other half in return for the new owners' commitment to invest an equivalent amount in the enterprises (chapter 4). However, subsequent fiscal problems led the Bolivian government (the successor administration to the one that initiated the program) to reduce benefits to older citizens.

Conclusions

The case studies and analyses presented in this book add substantially to the previously limited knowledge about privatization's effects on wealth and income distribution. Still, these and earlier studies are drawn from a limited set of countries and sectors. Such critical regions as Africa are almost entirely overlooked.[21] While the distribution issue has received great attention in Latin America, most studies of that region, including those in this volume, deal mainly with infrastructure privatization. Little is known about the distributional effects of many privatizations of firms producing tradable or other goods in competitive markets—from large steel mills to small hotels and shops. Our observations on privatization's effects on asset ownership and wealth distribution depend heavily on findings from transition economies of the former Soviet Union and Eastern Europe,

21. One exception is the Jones, Jammal, and Gokgur (1998) study mentioned above. For reviews of the economic and performance effects of African privatization, see Appiah-Kubi (2001), Due and Temu (2002), Temu and Due (1998), and Nellis (2003).

especially Russia. These findings arise from initial conditions that, if not sui generis, are thoroughly unlike those encountered in other regions and settings, or even in other transition countries; for example, the outcomes reported in China differ markedly (see chapter 11).

A second limiting factor is that privatization has been, for the most part, a phenomenon of the 1990s. To date, understanding its effects has been based on studies undertaken shortly after its implementation, during a period of general economic boom. Static snapshots, mostly taken within three or four years after the event, cannot tell the whole of what is clearly a dynamic story. It is thus too early to conclude that privatization should be delayed or accelerated across the board—certainly not because of its distributional consequences.

To illustrate, in the mid-1990s, the Czech Republic's early, rapid, and massive privatization program was judged a great success. As more information became available and problems of both performance and fairness surfaced, the consensus interpretation soon shifted sharply toward the negative. In Poland, by contrast, observers were at first critical of the country's hesitant approach to the privatization of large firms, but then switched to greater enthusiasm as the country returned to growth and macroeconomic stability. Indeed, Poland's overall solid performance, in the absence of large-scale privatization (combined with comparatively poor performance in rapidly privatizing Russia and the Czech Republic), led some to question the importance of rapid and massive privatization and others to emphasize that quick privatization in the wrong environment could have deleterious effects altogether. Now the pendulum has once again swung back. The Czech Republic, and to a lesser extent Russia, have returned to stability and growth; Poland's recent fiscal and economic problems are partially attributed to its failure to privatize the set of large lossmakers when it had the chance. One could show similar shifts in interpretation and judgment over time in numerous other countries, including Argentina, Bolivia, and the United Kingdom.

Nearly all these shifts in interpretation have been based on variations over time of financial and operating performance of privatized and state firms, not distributional consequences per se. However, as we have demonstrated, many distributional outcomes depend largely on the efficiency and productivity results of privatization; shifts in interpreting privatization's overall economic consequences also imply changes in the assessment of distributional effects.

Moreover, there is the obvious question: Are observed changes in income distribution associated with privatization or other simultaneously occurring reforms and policies? Pioneering studies (Galal et al. 1994; Newbery and Pollitt 1997; Jones, Jammal, and Gokgur 1998; Domah and Pollitt 2000) construct elaborate counterfactuals that attempt to assign to privatization only those performance shifts clearly caused by ownership change. These studies estimate what performance would have been had the firm not been privatized and attempt to determine the winners and losers from the privatization event. All yield a wealth of insights; however, all the authors in this volume readily admit that counterfactual construction inevitably contains speculative elements. With greatly varying degrees of rigor, led by the Latin American cases, all of the chapters in this volume grapple with this complex issue.

The many other reforms and changes that commonly accompany privatization matter, particularly with regard to distributional effects. Initial conditions, degree of competition, market structure, and level of institutional development all affect firm performance, in some cases as much as or more than ownership type.[22] Thus, more than ownership change is required for most low- and middle-income people to benefit from privatization's efficiency gains.

Despite these limitations and concerns, preliminary conclusions can be drawn. In line with the structure of this volume, we divide them into two parts: Latin America and transition and Asian economies.

Latin America

Privatization has been unfairly criticized in Latin America, in part, because it was the most politically visible, structural reform in that region during the 1990s, a disappointing decade of reform without growth. The studies in this volume confirm that the major privatizations of infrastructure have generally increased access to power, telephone services, and water, particularly for the poor, who, before privatization, often had no services or paid higher prices for private services (particularly in the case of water). Although some privatized firms have raised prices, which has burdened lower-income households, the bottom line is still one of absolute gains in welfare for the poor (though not general improvement in the distribution of monetary income). At the level of transactions, these findings are consistent with evidence that the effect of major structural reforms as a whole was to slightly worsen income distribution in Latin America; however, among other reforms, privatization offset the greater worsening effects of financial-sector reform and opening of capital markets (Behrman, Birdsall, and Szekely 2000). In addition, privatization of what had been loss-making state enterprises has freed up as much as one or two percent of GDP, providing Latin American governments with 5 to 10 percentage points of additional revenue. Though no definitive causal connection can be made, the

22. See footnote 1 (Tandon 1995); see also Newbery and Pollitt (1997). Sachs, Zinnes, and Eilat (2000) estimated the relative power of ownership change versus nonownership reforms in explaining privatization outcomes in transition economies. They conclude that both matter; however, in the absence of privatization, the same nonownership changes produce a less positive outcome.

resulting fiscal space probably made it easier for governments to finance their increases in social spending—of 10 to 20 percent in many countries—during the 1990s.

On the other hand, privatization was generally carried out without thought to its potential to reduce the region's high inequality, with the sole exception of Bolivia's capitalization program. The objectives were to reduce the burden of losses on the state and attract new investment. Obviously more remains to be done. Estache discusses the needed next steps in chapter 8.

Transition and Asian Economies

In the early 1990s, expectations were high. Privatization was at the leading edge of what should have been a rapid shift from a centralized economy to an efficient and equitable market economy. In hindsight, the transition was both slower and more uneven than anticipated. During the 1990s, inequality rose rapidly in most transition economies. Across countries, however, there was no particular association between amount of privatization and degree of increase; slow and fast privatizers were found at both ends of the spectrum. More likely explanations were the method of divestiture used; the type of new owner installed; sequencing and intensity of other market reforms; and the nature and density of the prevailing institutional framework in the country before, during, and after privatization events.

In retrospect, while privatization should shoulder a portion of the blame for the problems and corruption that occurred (e.g., in Russia, as argued by Glinkina in chapter 9; Georgia; and many other transition countries), it should also take credit where the shift was more rapid, deep, and successful (e.g., Estonia and Hungary). Moreover, in certain cases, such as Ukraine (see chapter 10), one can argue that, despite serious implementation problems, privatization still offers the best hope for a more efficient and just economy. The distributional outcomes of privatization in the transition economies of the former Soviet Union and elsewhere, including Asian economies (e.g., China and Sri Lanka), are more the result of, rather than a contribution to, a country's concurrent institutional and political setup.

In the case of infrastructure, on which much of the distribution debate is centered, many studies (see chapters 4, 6, and 7) focus on the existence or absence of an independent, accountable regulatory regime, not simply in law but in practice—that is, one that can design and monitor contracts; offer economically reasonable, legally enforceable rulings; lead or cajole government to honor its obligations; and resist capture by private providers. The better the regulatory regime, the better the distributional outcome of the privatization of electric power, water and sanitation, and telephony. A practical implication of this finding is that selling governments and those that assist them should invest more upfront attention and effort into creating and reinforcing regulatory capacity. This means taking the time to lay the institutional foundation on which distributionally positive privatization is based. In the United Kingdom, for example, it took many years for regulators of the privatized electricity industry to master the skills needed to squeeze out benefits for the average consumer (Newbery 2001). If that is the case in an OECD setting, what should one reasonably expect from new regulators in developing and transition countries?

Our advice is to move slowly, at least with regard to infrastructure privatization. That is not a costless prescription. The period between initial construction of a regulatory regime and assessing whether it is in proper working order could, and probably will, be long. In the interim, losses in the affected firms could continue to mount, opposition to reform harden, and reformers grow weary or disillusioned. Nonetheless, the prescription holds. Effective regulation is a double winner: Necessary over the short term to minimize troubling distributional outcomes, it is equally important to maximize efficiency.

Selling governments can and should do more in their privatization programs to maximize potential distributional gains. These cases and studies demonstrate that it is possible for governments to design and implement privatization to obtain gains in efficiency, at least without harming, and perhaps even improving, distribution. It is wrong to dismiss equity problems as the unavoidable, temporary price paid for putting assets back into productive use. As McKenzie and Mookherjee document in chapter 2, efficiency gains do not automatically imply equity losses or increased poverty.

Societies might even reasonably choose a less efficiency-oriented approach first to diminish longer-term risks to efficiency and growth that initial resulting inequities would undermine (e.g., through corruption or rent-seeking). Minimizing the sometimes real inequity in privatization, and—just as important—countering the misperception that it is inevitably unfair is important in order to preserve the political possibility of deepening and extending reform. In the end, a democratic government cannot implement reform when the majority of the people openly protest it, and no government can enact reform if it is not in power.

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