PRIVATISATION OF PUBLIC UTILITIES: THE OECD EXPERIENCE

Stilpon Nestor and Ladan Mahboobi (*)

I. Introduction and summary

Only a decade ago, privatisation was a highly controversial policy. In the OECD as a whole it affected a relatively small amount of assets: no more than 20 billion in the then 24 member economies,. By 1997, global privatisation proceeds increased dramatically to reach $153.8 billion, which compared to the 1996 figure of $97.2 billion, represents a 58 per cent increase[1]. Preliminary data from 1998 indicate a drop from the 1997 record number: global privatisation proceeds reached $114.5 billion, or 25% less than the year before. Nevertheless, within OECD the strong trend for further offerings seems to have largely survived the difficult market conditions of 1998, as privatisation proceeds only fell by about 10% .

In its early years, privatisation activity was largely confined to the tradables sector of the economy, but in the last 15 years sales of publicly-owned utilities have come to account for much of the privatisation activity around the world. In OECD area infrastructure sales have raised close to $270 billion (see chart 1) in the period 1993-98. In 1998, they accounted for almost 70% of OECD receipts (see chart 2) Privatisation has resulted in one of the most swift and dramatic changes of context for utilities and infrastructure industries. Intense global competition between large multinational (both in terms of operations and ownership) companies with deep roots in the capital markets has replaced a landscape of national, over-regulated monopolies in fragmented markets, financed primarily through budgetary sources -- mostly, deficits.

There are a number of reasons for this change. To begin with, the global political developments have removed or radically altered some perceptions about the control and distributional function of utilities; some of the strategic underpinnings for maintaining a tight state control over them, especially in Europe, vanished with the collapse of the iron curtain. The generally poor performance of public utilities, and changing views on the role of the state in the economy, have meant that public provision of infrastructure fell from grace. Growing demand for more and better quality infrastructure services, has increased the need for infrastructure investments at a time when budgetary constraints have limited the scope for government funding; this has provided further impetus for the change in the governments' approach to such investments. In the capital markets, financial deregulation has introduced new suppliers of equity capital into-cross border investment, making private provision of utility services possible; and the markets themselves were in need of quality stock to satisfy growing demand by pension funds and other financial intermediaries. Finally, technological developments in telecommunications and electricity generation industries have reduced capital intensity, and the lead times involved in the provision of services, and thus expanded the potential for competition in activities that were once dominated by monopolies.

In pursuing privatisation policies, governments have sought to achieve, economic, political and financial objectives. These objectives are often inter-related, and at times conflicting. The relative weight of different objectives varies among countries, and over time even within the same country.

---

* Stilpon Nestor is the Head of Privatisation and Enterprise Reform Unit, OECD, and Ladan Mahboobi is a Consultant at the unit. The opinions expressed in this paper are the authors' own and do not necessarily reflect the views of the OECD.

Evidence on privatisation experience to date has consistently shown that a change in ownership has improved performance considerably at the firm level, both in terms of productive efficiency and profitability. In terms of financial objectives, such as fostering the development or further expansion of equity markets[2], privatisation has been a great success. In terms of economic objectives, privatisation has generally had a positive effect on consumer welfare as the separation of commercial from the non-commercial functions has allowed for a more transparent allocation of resources, thereby diminishing rents. The degree of success, however, has depended on the post- privatisation market structure, and the introduction of competition; or the existence of effective regulatory regimes, where introduction of competition was not possible and natural monopolies persisted.

In this paper, we will first discuss the development of the public policy debate on the ownership and control of utilities and the case for their privatisation from four different angles (II). We will subsequently turn to a discussion of the changes that occurred in the institutional approach to utilities and infrastructure (III). An analysis of key privatisation objectives will follow, which will also include discussion of the impact of different privatisation methods on achieving these objectives (IV). In part V, we will discuss the importance of competition as an objective and its relationship to infrastructure privatisation. Finally, we will offer some conclusions.

II. Public ownership of utilities and the case for privatisation: what has changed

By "Public Utilities", we refer to network infrastructures that provide a range of essential goods and services to households and firms. They supply their product/service through a fixed network of pipes, wires or other facilities. In most cases, these monopolistic firms were vertically integrated: they provided for production (including in some cases the exclusive right to import), transmission and distribution to the final customers. Moreover, in the case of some industries such as electricity, the lines between different parts of the vertical stream were blurred. As a sector of the economy, utilities are quite significant. Often their value added accounts for a preponderant share of the GDP, and infrastructure investments, account for an even larger portion of total investment**.** Their importance is, however, mostly due to their pervasive role as an input to all other industries.

In a large number of OECD countries (with the notable exception of the US), these industries had been under state ownership and control for a good part of the 20th century. Viewed as natural monopolies, and regarded as strategic and sensitive from a national security perspective, they were afforded a statutory monopoly status, even in markets for goods and services that did not warrant such a status (e.g., telephone equipment in the telecommunications sector). In most cases, the mandate of these enterprises included both commercial and regulatory functions. Only in the last 15 years has there been a reversal of this trend through an attempt to carefully separate public welfare/policy functions from commercial ones. One can view the reasons for this transformation through four different angles; (a) political /philosophical; (b)institutional and corporate governance structures; (c) economic and industrial organisation ; and (d) financial. All of them are important for understanding the fundamental change of landscape that is currently occurring on a global scale in the area of utilities.

a. Political and philosophical

Up until a decade ago, close control of infrastructures was dictated by reasons of national security, social peace and economic equality between citizens of most OECD countries. In the wake of the second world war and with the cold war in full swing, these considerations were of utmost importance. Making sure that utilities were run in a way that kept the enemies of the nation at bay and these vital industries under clear national control was essential, in view of the imminence of the communist threat. At the same time, the political threat that communism represented made the pursuit of egalitarian/redistributional objectives necessary in the provision of utilities

Some of these state objectives of control were pursued by statutorily limiting ownership by foreigners[3]. Other countries imposed strict limits to the control of utilities, for example by prohibiting individual investors from acquiring substantial blocks of shares in utilities. But in most countries, these objectives were served by making the provision of utilities a state function, often by constitutional means.

The end of the cold war was a powerful catalyst in rethinking (and narrowing) the boundaries of national security. Suspicion between neighbours was further attenuated through regional economic integration, as in the case of the EU and, more recently NAFTA. Direct ownership and control of "sensitive" firms has been increasingly viewed as a grossly disproportionate response to a rather narrow problem. As a result, regulation and "golden shares", i.e. bylaw provisions that allow the state some veto power of corporate control moves that it deems harmful to the national interest, were seen as more appropriate tools. Countries started making use of international financial and know-how resources without many scruples. Many of the formerly state-owned utilities are now buying utilities in other countries[4]. From the UK to Hungary, industries such as telecommunications, water distribution and electricity, hitherto considered extremely sensitive, are today run by foreign firms (or owned by foreign institutional investors).

The OECD area has witnessed unprecedented prosperity during the post war period . This has meant that alleviating poverty through a redistribution of wealth has to a large degree been replaced as a priority goal with the need to advance consumer welfare, through lower prices, better quality and increased choice. While the provision of universal services remains in many OECD members a constitutionally protected right[5], it is also an objective that has been largely attained and the recipients are now looking for better and cheaper provision of utility services.

Governments thus came to recognise politically what economists have long preached: consumer welfare through more, cheaper and better output depends on allocative efficiency with competing producers in factor and product markets and on higher productive efficiency in the use of inputs by individual firms through better incentives and finance mechanisms. Core economic objectives are once again taking centre stage in the provision of utilities.

Preserving employment in large SOEs has been the most politically sensitive and hence the most resilient non-commercial objective. Most privatisation officials will admit that more than 70% of their time is devoted not to designing privatisation policies and supervising transactions but in talking to the public sector trade unions. Contrary to popular belief, experience seems to show that while many of the privatised companies shed labour in the short term, this has not necessarily made labour worse-off as a group. Appreciation in the value of shares acquired in the privatised enterprises, generous severance packages, and more importantly improved economic conditions that permit absorption back into the job market have led to this result[6]. In the long run privatisation produces new employment opportunities due to the considerable output expansion that it usually generates. However, the experience of many "sunset" sectors (such as coal and steel, but not utilities) in some OECD countries has painted privatisation as a "job killer" in a seemingly indelible fashion[7].

b. Institutional and corporate governance structures

The weight of non-economic objectives in the provision of utility services was directly reflected in their institutional profile. Utilities were considered either an integral part of the state (i.e. part of ministries) or were constituted as autonomous state entities, of a non-commercial nature (Guislain 1997). In most countries, the pursuit of non-commercial objectives was considered easier through state ownership than through arm's length regulation, as information asymmetries between the state (the principal pursuer of these objectives) and the firm as well as transaction/administrative costs of control were thought to be lower under such arrangements.

By the mid-seventies, the state ownership and control arrangements for utilities had become obsolete and even pernicious to the objectives they were supposed to serve. Politicisation, of economic decision-making is synonymous with state-ownership (Boycko, Schleifer and Vishny 1996). Decisions on matters such as personnel, output, prices, quality, and location of production were made according to political considerations. As a result some of the most important firms in the economy no longer served economic objectives: they were rather viewed as a way to provide for employment, serve regional development objectives, or increase the prestige/status of the country and its government (in the best of cases). Managers of state-run utilities were often, as a matter of course, political appointees and their employees were given a status equivalent to that of civil servants. As utilities occupy a neuralgic position in the economy, these patterns had an important impact on the rest of the economy and the overall allocation of resources. Evidence of the spillover was the creeping tendency to nationalise additional parts of industry and (especially) the financial sector.

The second result of politicisation was unexpected by the proponents of public provision of basic services; it undermined the very goal of a public spirited, non-commercial utility provision: accountability has proven to be extremely weak in the public sector. In other words, the principal-agent problem proved to be especially hard to address in the context of state ownership[8]. The absence of exit for the state as shareholder further compounds the agency problem and makes the valuation (and hence the policing of performance) of SOEs extremely difficult (Alchian and Demsetz 1972).

Conflicting, unclear and shifting political objectives and responsibilities are hard to pin down when the ultimate owner is the population at large via the Parliament, the government, individual Ministries and their bureaucrats. Thus, opportunistic behaviour became the norm as the cost of opposing powerful vested interests in some of the most important firms was prohibitive to bureaucrats and politicians. In the real world, the limits between negligent waste and conscious looting and corruption in the public sector became more and more blurred in many OECD countries-- not to mention the developing world.

Some have argued that weak monitoring and opportunism are an externality to the type of ownership: (Stiglitz 1993). After all, there are countries where such looting did not take place because of strong traditions of integrity and honesty in adequately remunerated public sectors. Even there, however, SOEs were not spared the hazards of principal-agent problems as efforts short of privatisation to separate economic/commercial from non-commercial objectives within the public sector (see below) met with only limited success. The absence of a direct profit incentive, always introduced an element of distortion in corporate strategies: insiders felt much freer to pursue expansion and grandiose projects without a proper cost-benefit analysis simply because the benefits were more visible than the costs in a politically-determined control environment.

Privatisation is, in this perspective, a response to the institutional failings of public ownership, to the state's weakness as a corporate governance principal. Any saving from internalising externalities through state ownership in the area of utilities, by aligning commercial and non-commercial objectives within the firms, were largely offset by this weakness, and the perverse incentives it generates. In this respect, technological innovation also helped in tipping the scales in favour of privatisation. Transparency in arms-length relations has become much cheaper, due to progress in information technology. This implies that arm's length regulation is now less costly than outright ownership; and it suggests that the corporate governance of widely-held private companies is also becoming more effective: information asymmetries between shareholders and companies are becoming less pronounced, hence, corporate control can be more efficiently exercised through the markets.

c. Economic and industrial organisation aspects

Better corporate governance improves productive (or x-) efficiency in individual firms by allowing for a better utilisation of resources; and it has a positive impact on overall allocative efficiency in the economy by making the allocation of financial resources more transparent. But the biggest incentive for improving x-efficiency is competitive pressure. Most importantly, allocative efficiency in the economy as a whole will not get any better if there is no competition in the relevant product and factor markets.

In most cases, utilities have been natural monopolies in the past. Economies of scale have allowed for only one producer in these markets especially at the level of transmission and distribution. Contestability has, in theory, been always possible at some level or other; for example, electricity generation could always be a competitive business in theory. Most people assumed, however, that the presence of huge, lumpy, firm-specific investments, high capital intensity, enormous up- front entry costs and a downstream monopsony would deter most potential competitors from entry. As a result complete vertical integration prevailed in most utility sectors in OECD countries.

The implications for consumer welfare of monopolistic pricing and output decisions are judged to be pernicious by the great majority of OECD countries who dispose of competition legislation to address such situations in the private sector; hence, the need to closely regulate natural monopolies. In the US, arm’s length regulation was deemed sufficient from the start. The government response to the natural monopoly features of the industry was to have them operate as a regulated privately-owned monopoly, with universal service obligations and cross-subsidies built into tariff structures. In most other OECD countries, state ownership was preferred mostly on the assumption of transaction cost efficiencies from internalising the regulatory externalities, political expedience (discussed above) and financing reasons (discussed below)[9].

Technology has been a key factor in bringing about change. It has caused economies of scale requirements to shrink dramatically in many sectors. Developments in the telecommunications industry provide a prime example of a hitherto vertically integrated monopoly that is now an entirely competitive industry in many countries. The possibility to effectively and cheaply meter consumption and measure flows in electricity and gas networks has unveiled a hitherto unknown potential for third party entry. Upstream segments of infrastructure markets became truly contestable as deregulation allowed already established providers/producers from different geographical markets to directly compete. That has been the case with US deregulation of the electricity industry in the late 1970s and it is actually taking place in Europe through European Commission directives in the areas of electricity and telecommunication. More generally, the possibility for private agents to challenge existing monopolies was considerably enhanced by allowing foreign firms and investors to participate in their provision.

In most countries, contestability came to the fore with the arrival of big foreign players on the scene. Vertical disintegration started making more sense as the possibilities of vigorous competition emerged. Conversely, partly- and wholly-privatised companies, freed from stringent regulatory requirements that limited their geographical and product market scope, became important international competitors in their own right and thus maintained and intensified the privatisation momentum in countries other than their own. A series of acquisitions by US and French companies in several UK utility sectors and the on-going consolidation of the Nordic Telecoms industry testify to the powerful impact of globalisation.

Technological innovation, deregulation and openness to foreign investment have been driving forces in introducing competition in utilities. But certain areas still remain closed to competition due to natural monopoly characteristics. These are, however, quite narrow areas, mainly restricted to the fixed network and the large sunk investments that constitute it. Development of competition upstream has meant that privatisation could also be envisaged as a possibility for these monopolies. This is because the ending of cross- subsidisation (following vertical disintegration) makes their cost structures more transparent to regulators (Bitran and Serra, 1997).

d. Financial aspects

One of the main reasons for utilities and infrastructures to come under the government's purview in the 1950s and 1960s was the perceived lack of resources in the private sector to finance their rapid and wide expansion. Financial markets were fragmented into closed national areas with low liquidity and insufficient savings. Equity markets were narrow and illiquid in the great majority of OECD countries. Corporate bond markets were a little more developed but puny in relation to sovereign debt issues. International capital flows were not only a small fragment of what they are today; they were also largely dominated by direct sovereign lending (or aid) and other debt flows explicitly or implicitly guaranteed by governments.

In this context, it seemed natural to choose government financing as an effective way of backing expansion in these resource-hungry, capital -intensive industries. Moreover, the risk premium that OECD sovereign borrowers commanded in international issues, combined with the fixed exchange rates of the Bretton Woods environment, allowed for significant deficit financing of these industries.

But financial markets have changed enormously during the last three decades. Floating exchange rates since the early 70s have rendered large budget deficits to finance public investment unsustainable as monetary policy could not anymore be exercised in a vacuum. Similarly, the alternative of printing money, proved to be catastrophic as the OECD area went through its worst inflation spell twenty years ago. Enterprises found themselves constrained, instead of cushioned by public ownership (Moore 1986). Many OECD countries were unable to provide for adequate levels of investment in infrastructure with the result being a continuing deterioration of networks and technological backwardness. Others (such as France) managed to maintain an adequate level of public financing for another decade or so by increasing the fiscal burden; but that too proved unsustainable. It is not by accident that the most intensive privatisation programs of recent years has materialised among EU countries in the run-up to the EMU[10].

The growing demand for new and better infrastructure services in a tight budgetary environment paved the way for greater private sector involvement in funding and providing such services, as a means of reducing governments' budgetary exposure.

Financial market liberalisation and globalisation trends intensified since the beginning of the 1980s. Bank dissintermidiation grew while the managers of an increasingly large pool of private savings have been chasing investment opportunities, bringing the cost of capital down for the companies in a position to tap into this pool . Privatisation became a prerequisite for large companies seeking to access this pool. More than 25% of international equity issues were privatisation transactions in 1997 (see chart 3)-- a steady growth from about a 5% average in the 1980s (OECD, FMT: No. 70 and 60).

From a financial investor's perspective, privatisation is a part of current changes in European/Asian corporate control structures. Dominant shareholders are in the process of making their holdings transparent, structuring their relationship to the underlying companies on an arm's length basis and, most importantly, divesting all their non-core holdings. German banks have been distancing themselves from their equity holdings, French corporates are severing their cross-ownership links, the Japanese keiretsu are under threat as banks are cutting their links with industry in an attempt to restructure their loan portfolios and the Korean chaebol are forced to rationalise their operations and turn into real publicly-held companies in terms of their control (Nestor and Thompson 1999).

In the same vein, the state's control over large industrial companies is increasing the latter's cost of capital: as a result of the disintermediation trend noted above, debt financing (a classic form of financing SOE development) is becoming considerably more expensive than broadly based direct-equity finance. SOEs not only need to access the equity markets through privatisation; like private companies in the countries mentioned above they also need to meet the information and governance requirements that broad-based international private ownership implies.

III. The great institutional re-alignment: changing incentives and separating objectives

a. Separating commercial from the public policy objectives

The technological, political and economic changes as well as new financial market trends have made it extremely important for OECD governments to re-introduce commercial, market-oriented incentives in the provision of utilities. At the same time, the state retains a legitimate and very important role as the guarantor of an adequate provision of these fundamental services, that should be available to all at a reasonable cost. This continuing and important public interest consideration is what distinguishes utilities and infrastructure from other privatised or privatisable companies in industry or finance. The way to achieve these two different and often conflicting sets of objectives is to assign them to different institutions: the state and its regulatory institutions would take care of the public interest while the providers of utilities would be private, profit-oriented agents of the privatised enterprises functioning according to commercial criteria and assuming the commercial risks associated with the economic activity.

From a theoretical perspective, privatisation is in fact the obvious solution when the commercial/profit related objectives are predominant and can be separated from the public interest objectives in a meaningful way (Stiglitz 1993). When the commercial objectives are too narrow and limited as opposed to predominant public interest ones (especially in the provision of public goods, such as health care, education, public security), the case for privatisation is less clear cut. The benefits of separation should then be weighed against the cost of writing increasingly complicated regulatory/contractual arrangements ex ante[11]. In such cases the possibility of efficiently separating the two functions should be closely examined on a case by case basis .

The separation of commercial from public interest functions has two implications: on one hand, it results in the creation of an arm's length relationship between the state as regulator and the commercial firm as producer of goods and services. On the other hand, it begs for a clear differentiation between shareholder and regulatory functions within the state. In most OECD countries line ministries gave way to treasuries in managing the shares of SOEs (whether the latter were partially privatised or not). This ensures a better separation between the commercial objectives (i.e. return on investment) that the state pursues as a corporate governance principal from the public interest objectives that it pursues as a regulator. It also addresses some concerns about capture of the "line" authorities by the enterprises and their insiders (Pebble 1996). The asset management function of the state has been continually extended to include a flexibility that was previously associated only with private agents. In Sweden, a new asset management unit has been recently (early 1999) set up, with a mandate to commercially manage stakes in 59 major industrial companies (including telecoms and airlines); this mandate extends to the right to sell shares in these companies when it deems that exit is a sound investment solution.

The creation of an effective regulatory framework to address competition policy failings in the commercial utilities provision is the other component of the reforms. It is beyond the scope of this paper to discuss these issues in any detail. Suffice here to note that the need for industry- specific regulation, the content and institutional form of regulation depends on a number of factors: the level of actual or potential competition and the actual or latent market power of the incumbent; the particularity of market access in the sector (issues such as licensing, fair network access etc.); the need to minimise information asymmetries between the regulator and the firms; and the need to avoid capture of the regulator by the regulee (Beesley 1994 and Bitran/Serra 1997).

b. Restructuring public enterprises without privatisation

The first step toward the separation of commercial from non -commercial objectives is the corporatisation of SOE, i.e., their transformation into a full blown commercial company, subject to private law requirements and obligations and having the same legal governance structure as any other commercial entity. Corporatisation might be a long and complicated process, as, in many cases utilities were the successors of government departments. The intense due diligence exercise that is needed to identify assets relevant to a company, value them and legally assign them to the new company is trying, especially when it is met with hostility from the employees of both the enterprise and its ministry of tutelle. The corporatisation of British Telecom lasted almost two years, while that of France Telecom took more than one. In Netherlands, SOEs are usually given 5 years between corporatisation and privatisation, so that they can establish a credible track record.

One of the most important changes that corporatisation brings is transparency: by adhering to a corporate accounting standards applicable to the private sector, the previously unpenetrable picture of the enterprise's use of its assets become clearer. This gives to both the public and the government a better idea of the costs involved in particular strategies and decisions related to the development of utilities. It brings forth the problems related to the financial structure of companies and often obliges the state to assume directly certain liabilities, in order to improve this structure: the corporatisation of German Railroads (DB) in 1995 resulted in the state taking over some DM 70 billion of debts (Ludwig 1996); an equally impressive financial restructuring had to take place in the commercialisation exercise for the French railroad company, the SNCF. Finally, hidden subsidies and cross-subsidies come to the fore; their need is reassessed and they are tackled in a more direct fashion. Corporatisation helps make the public interest aspects transparent and allows for better targeting of subsidies and adjustment policies.

Another benefit of corporatisation is the possibility to introduce new management and board of directors that will function and, most importantly, get paid according to private sector rules. In fact, a lot of the "privatisation" benefits started to be observed in companies even before they were taken to the market, simply because the new management that was put in place under corporatisation was able to function under business rules and not as a government unit. Both New Zealand and the UK made managerial restructuring and the introduction of board autonomy a central part of their commercialisation programme.

However, company law requirements are hardly sufficient to stop governments setting alternative objectives for corporatised SOEs. Moreover, the more complicated accountability line of company managers-- as opposed to bureaucrats directly responsible to a political master -- might actually encourage managerial opportunism. Even in the face of increased transparency, it is possible that a corporatised, 100% state-owned entity is subject to the worst of both worlds in terms of corporate governance: the profit incentive is lacking and the state/owner has less power to monitor and police managerial performance. In order to address this corporate governance problem, corporatised SOEs in the Netherlands are required to obtain direct permission for any important managerial decision from their shareholder, the Ministry of Finance. These requirements are automatically cancelled when a percentage of the shares are offered to private investors.

In order to address some of the incentive issues, governments came up with a set of alternative solutions to measure performance and improve governance in the public sector. The so-called framework contracts became the major tool for measuring and policing performance and corporate behaviour; they assume that the firms are sufficiently identifiable (i.e. usually commercial corporations) and can be treated as an arm's length partner of the state. The framework contracts provide for the periodic setting of corporate goals between the state and the enterprise on the basis of a given stream of revenues and the provision of a level of investment financing[12].

From an incentives point of view, performance contracts have sometimes tended to increase information asymmetries between the state and its companies, as managers had additional reasons to demonstrate improved performance but were not constrained by share prices --i.e. when faced with a choice, they would pursue projects that generated more free cash flow, that they could then use for their own intra-company objectives; or they could opt for highly visible employment-intensive or "white elephant" type projects that would give them political points. In any event, performance contracts were rarely perceived as really binding on either of the two parties. Moreover, in the absence of tradable shares, valuation (and hence performance evaluation) became a negotiation process between managers and their bureaucratic supervisors. Empirical studies have shown that performance contracts have proved to be largely ineffective over time. (Shirley 97).

But the most important incentives for firm restructuring and increased profitability remained the threat of competition, on the one hand, and the ultimate objective of privatisation on the other. Most of the governance benefits associated with the adoption of a commercial framework for the activities of a firm remain pretty elusive if the transformation of an SOE into a 100% state-owned company is all that is in the cards. State run-airlines in France and Spain are cases in point: while being corporations for some time, the fact that their privatisation was not envisaged did not impact the level of politicisation which remained very high. Management contracts with professional managers did not seem to have any positive effect on the running of the companies. It was only with the announcement of ownership transfer that commercial incentives began to play a powerful role.

In order to address these issues while retaining some level of state control, governments have tried to partially privatise their companies. Partial privatisation results in a better valuation of the company; it increases the flexibility of its financial structure; it makes it possible to introduce real performance-related incentives in managerial remuneration through stock options; it focuses boards and management on producing shareholder value, as opposed to the pursuit of "political" objectives; it further increases transparency by imposing on the company disclosure requirements for public companies[13]. But it has its limitations too: in order for partial privatisation to work, the state must renounce political interference; most importantly, it has to convince the markets that it can be trusted to do so. Recent events in Greek Telecommunications OTE, where the minister simply sacked the CEO in spite of a 35% stake in the company floated, indicates that old habits are hard to break. On the other hand, the absence of a market for corporate control in the company's shares might result in less capital market discipline. If the state desists from exercising its shareholder rights, this would leave ample scope for managerial discretion (Jasinski and Yarrow 1995). Similarly, if the state decides to float only a small fraction of the equity, the market might remain unconvinced about the government's commitment to pursuit of commercial objectives. For example, in the case of floatation of 10% of Telecom Korea shares in 1993, the government had a hard time finding buyers for its shares.

IV. The objectives and results of privatisation

Privatisation is often part of a broader reform of the role of the state in the economy that usually includes regulatory reform and the introduction (or enhancement) of competition policy as a means to promote public welfare (Stiglitz 1993). Privatisation policies have multiple, and often inter-related and conflicting political, economic and financial objectives (Guislain 1997) These include:

- *Changing the corporate governance environment of SOEs and improving their productive efficiency and performance by introducing incentives based on private ownership rather than bureaucratic oversight.*

Better corporate governance should be the primary concern of every privatisation policy. Schemes that aim to raise capital for the budget without change in governance incentives and structures in companies (for example through the retention of substantial majority rights or the creation of cross-shareholding and closed "stable cores") do not bring most of the long terms benefits of privatisation to the companies or the economy as a whole (Nestor 1998). Countries that have pursued these policies in the past such as France have gradually abandoned them, having realised their high opportunity costs for the firms involved (Morin 1998). The new generation of stable shareholder arrangements in privatisation are designed to address mostly issues of financial stability in countries with shallow, volatile stock markets with relatively low institutional involvement (Grilli 1997). Their main characteristic is that they expressly prohibit shareholder agreements and provide for relatively-market friendly arrangements for the stable shareholders (as opposed to the older French "noyaux dures" that mandated concerted action by shareholders and allowed no exit).

In terms of corporate governance results, Megginson et al (1994) have found that newly privatised firms show an unusually high turnover of board members: more than 50 per cent of directors of SOEs leave after privatisation. Moreover, they have found that newly privatised firms with high managerial/director turnover are among the highest post-privatisation performers in their sample[14].

Another important aspect related to corporate governance has to do with the change in the capital structure of the firm after privatisation. As firms become much more equity oriented there is more pressure to produce shareholder value. This is reflected in the setting up of investor relations departments and the hiring of consultants to "sell" the firm in the market. In general, there is a change of attitude as regards risk and growth: privatised firms become much more willing to take investment risks as their debt/equity ratios improve.

A better incentives structure and corporate governance are important because they lead to better firm performance. Evidence in this respect is quite straightforward. In a survey of empirical studies of the performance of privatised firms in the UK, Holder (1998) has found that labour productivity considerably increased as a result of privatisation, and in some cases total factor productivity increased too. Newbury and Pollitt (1997), have calculated that return on assets in the privatised electricity generating companies increased by 40% (in the five years after privatisation). Megginson et al (1994) have found important increases in profitability (net income/sales) and efficiency (sales/employee) in their sample of 61 companies from 18 countries. In the same vein, La Porta and de Silanes (1997), have found that sales per employee roughly doubled after privatisation in 218 Mexican firms divested in the late 1980s-early 1990s.

- *Providing better access to finance for enterprises to generate higher levels of investment*

With privatisation, enterprises are freed from public sector constraints on investment. They can tap the unlimited supply of the capital markets without any impact on the state budget. Even if competition can be introduced without privatisation, the competitiveness of enterprises cannot be ensured without proper access to finance. As noted above, competition without privatisation would actually harm SOEs, as they will not be on a level playing field with their competitors in terms of raising capital for their growth and expansion. In this respect Galal at al (1994), have found that "..relaxing an investment constraint had a significant positive impact...". In the area of infrastructure, increasing investment is indeed one of the top priorities, and evidence from OECD (as well as non-OECD countries) suggest that privatisation has led to substantial increases in investment. In the UK, important net increases in firm investment were observed in all utility areas, irrespective of the post-privatisation market structure (Holder 1998).

- *Creating a windfall for the state budget, and improving certain macro economic indicators, notably public debt and the public sector borrowing requirement; improving medium term budgetary revenues.*

These days, improving public finances is the most obvious privatisation objective. Despite the difficult market conditions of 1998, OECD countries raised some $86 billion in privatisation proceeds. The importance of these revenues for the government budgets is telling, especially for the members of European Union which raised more than two thirds of this total, and have been engaged in meeting debt and deficit targets in the run up to the EMU.

One should note that the direct budgetary impact of privatisation proceeds is rather minor in most systems of public accounts as it replaces assets with cash -- an operation which in principle should add little to the asset side of the state budget. It might however have significant indirect effects on the budget, all of them welcome in a period of macroeconomic belt tightening. On one hand, it lowers the public sector borrowing requirement. In some countries (e.g. Italy) privatisation revenues have been explicitly earmarked as a means to reduce the public debt. On the other hand, privatisation can be reasonably expected to increase the state's tax revenues in the medium term: as some of the enterprises were previously exempt from tax or had a favourable tax regime. But even more important is the growth in tax revenue which results from the increased profitability of the privatised firms. A study by NERA (1996) has put the net inflows to the UK budget for the last ten years, *in addition to privatisation revenue*, at between UK £ 3.5 billion to 5.8 billion[15], mostly due to higher tax receipts.

- *Deepening of the equity market and the creation of a wide share owning class and boost the role of equity markets as a means of channelling savings in the economy*.

In many countries this has been a key objective and has affected the choice of method of sale. In most European countries, broadening the equity market was an explicit objective; in the UK, it took an ideological importance during the Thatcher years. In any event, the long-term decline in UK population direct share ownership was reversed, with three times as many share owners in 1995 as there were 16 years before. (UK Treasury 1996). The importance of privatisation for the development of European equity markets has been enormous. Roscini and Esteve (1998) point out the overwhelming influence of privatisation issues: They account for more than 55% of the number of issues in the 12 larger European economies ; in Italy and Spain they represent more than 70% of the total market capitalisation. In terms of size, all of the very large (over $5 billion) and more than 70% of the large (over $ 1 billion) European issues were privatisation transactions. As noted earlier, this has resulted in the tripling and quadrupling of market capitalisation in many European OECD member countries.

- *Introduce competition in hitherto closed markets, thus lowering prices and increasing the quality of infrastructure products and services*

In the context of utilities, competition is often a primary objective. The reason is two-fold: (i) in contrast to other sectors, utility provision is often monopolistic (for a variety of reasons discussed above); and (ii) utilities provide services that are important for the well being of the economy, and for consumer welfare, and thus a highly visible priority of any public policy. Privatisation offers an opportunity to break up monopolies, and to improve allocative efficiency and consumer welfare.

Privatisation of public utilities provides a good example of conflicting objectives, such as the desire to maximise proceeds by keeping the monopoly status of the large formerly state-owned incumbent intact, vis-à-vis the objective of creating a competitive market structure. Creating competitive markets often suggests a break up of huge monopolies and the establishment of a rigorous regulatory framework in natural monopoly sectors before privatisation. On the other hand selling public monopolies as such would certainly fetch a better price for the treasury and is thus tempting, especially in situations of budgetary contraction. Buyers are willing to pay a premium for future monopoly rents. Moreover, allowing incumbents to tap the vast resources of the global capital market and hence develop into global market players might in the eyes of many policy makers become an irresistible temptation, as opposed to the longer term goal of a more competitive market structure at home.

Overall, privatisation has led to lower prices and improved service quality. For example, in his review of the evidence Holder (1998) suggests that privatisation of utilities has been beneficial to consumers in the UK. Only in case of water and sewage companies, where privatised firms were required to make significant investments for the maintenance of the network (and to bring up the quality to standards required by EU), did prices significantly increase in the aftermath of privatisation. Galal et al (1994) analysis of the welfare consequences of privatisation have also found important welfare gains associated with privatisation, with consumer welfare being one of the most important factors in these gains, especially in the UK case[16].

Some authors have suggested that one should be "agnostic" towards issues of ownership; introducing competition should be the only objective of public policy in the area of utilities (Vickers and Yarrow, 1988). This view seems to underestimate the practical difficulties of introducing competition and maintaining the momentum for improved efficiency without privatisation[17].

It has also been argued that the overwhelmingly positive post- privatisation corporate performance cannot be attributed directly to privatisation, as competition and other structural changes which occurred at the same time, could have also been responsible for the improved performance (Newbury, 1997). However, this argument seems to be based on a contradictory reading of the facts. On one hand, it assumes that increased competition and not privatisation was mostly responsible for performance gains in privatised firms; on the other, its autors suggest that because of the lack of competition, consumers did not adequately benefit from these windfall gains. In any event, it is also acknowledged that in the absence of privatisation, it is inconceivable that the changes would have taken place and the momentum sustained. In as far as the effect of market structure and firm performance is concerned, La Porta and de Silanes (1997) point out that the important performance gains they observed in their all-inclusive Mexican sample, were not linked to market power in any way; this suggests privatisation is the primary cause of these gains.

Having said this, most of the literature seems to point out that where improved competition was not a primary aim of utility privatisation, the impact on allocative efficiency (and hence consumer welfare) is less clear cut, even in the presence of clear performance gains at the firm level. The experience of two countries with long running utility privatisation programs (UK and outside OECD, Chile)[18] suggest that the difficulty of introducing competition post-privatisation (either through competitive restructuring or though regulation) was under-estimated and that it resulted in maintaining some price rigidities. The UK telecom and gas sectors are often cited as areas where the absence of a pro-active policy on the part of the state resulted in lower levels of consumer welfare through price reductions.

Matching privatisation methods and objectives

There are a number of privatisation methods:

- Initial public offerings (IPOs) in the capital markets
- Trade sales to strategic investors
- Management/Employee buy -outs
- Asset sales, often following the liquidation of the SOE

The choice of the method of privatisation depends on the country's characteristics in terms of capital market development and legal infrastructure, the size and nature of the enterprise in question, and the aims of privatisation. Methods of sale have significant implications in terms of the transparency of the process and its political credibility, corporate governance, financial market development, competition and political objectives.

In general, competitive privatisation processes breed better outcomes for the industries concerned. Countries that have chosen to limit competition in the corporate control market for privatised companies by directly or indirectly pre-selecting the new private owners have very often found themselves troubled by political controversy and charges of low transparency, favouritism and even corruption. Moreover, even where the state can be trusted to effectuate such operations with integrity and good judgement, the resulting combinations might often reflect the state's industrial policies rather than the interplay of market forces in the sector. In the case of France, we have already noted the reversal in the mid-1990s of earlier policies to design the post -privatisation ownership structure though arbitrary (and certainly non-competitive) transfers to preferred agents (Morin 1998).

Initial public offerings (IPOs) are an open competitive procedure that allow for share pricing and company valuations by the market. Building competition in the offering process itself, for example by creating tension between institutional and retail tranches in book building procedures, is important. In general IPOs are more appropriate for utility privatisation for two reasons: firstly, the maintenance of firm independence through stock market floatation, at least for the initial post-privatisation period, ensures higher transparency of its cost structure and financial flows (Jenkinson 1998); this is important for lowering information asymmetries between the regulator and the firm in question. Secondly, IPOs allow the firms to tap vast financial resources at a low cost and this satisfies the hunger for investment in infrastructure, that seems to be more prevalent than in other sectors.

IPOs are highly transparent methods of sale, but to be effective, they require deep capital markets, a sophisticated financial and legal infrastructure, and a few, large privatisation candidates. Most OECD member countries meet these conditions, thus IPOs have been the dominant method of privatisation (see chart 4). IPOs also require significant preparations and restructuring of the firms prior to the sale (Guislain 1997). Because of this restructuring effort, most of the corporate governance gains that privatisation brings, are realised at the pre-privatisation stage[19]. It is, important that the government follows through with privatisation immediately after restructuring has produced results and the company has established a satisfactory track record. If not, the gains might prove to be temporary and the signals sent to other SOE managers would be conflicting and counter-productive.

Trade sales to strategic investors are especially vulnerable to competition failings. The state is often tempted (or captured into) selling its controlling states to local interests with negative results on the competitiveness of industry; this is especially the case when the companies 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 trade sale transactions. Explicit or implicit limits on foreign participation in tenders is another common way of limiting bidder competition. While this is politically expedient, it does little to protect national interests since it prevents the emergence of efficient outcomes of privatisation processes. Foreign ownership, even in so-called "sensitive" sectors might bring substantial benefits to the domestic economy.

The main benefits that trade sales bring are the introduction of considerable managerial and technical know how and a stable investment environment for an economically important firm/sector. The latter is especially important for countries where capital markets are shallow and undue exposure of utilities to the vagaries of today's international capital movements might be deemed undesirable. Many smaller OECD countries have tried to combine the benefits of a trade sale with the capital market gains that a public floatation brings. The Czechs have sold 35% of their telecoms to a strategic buyer (with control rights) and have floated (or are planning to float) most of the rest in the stock market. A similar pattern was followed in Belgian energy and telecom privatisation. The corporate governance implications of these arrangements are yet to be discerned. In any event, the above pros and cons of trade sales explain why IPOs are a preferred method of utility privatisation in OECD countries while trade sales are more predominant in the developing world (OECD, FMT No: 70 and 72).

There is often a discussion as to whether SOEs are appropriate buyers of privatised infrastructure assets in other countries. It might be argued that if their own objectives are still obscured by non-commercial considerations and their incentive structures are distorted, they will not be very efficient agents of change in privatised companies. Moreover, they might prove to be formidable lobbyists in their efforts to limit competition, as they are often backed directly by their government's diplomatic and political weight [20]. In practice, however, these concerns might be overcome by the privatising government's resolve to resist capture. Therefore, the questions to be asked, in addition to the ones that are put to all bidders, is whether these SOEs operate under investment constraints or other severe corporate finance handicaps in their home markets, in which case they might be unable or unwilling to contribute to the long term development of the privatised firm; and whether they have an experience in operating in competitive product and services markets.

V. Introducing competition in the infrastructure sectors

a. Introducing competition before privatisation

We have already discussed a view in literature suggesting that privatisation is not important as the results of privatisation seem to derive mostly from the introduction of competition, and not the ownership change . In this context, it might be useful to discuss a few of the experiences in OECD countries with introducing competition before (or even, without) privatisation.

One attempt to create a "private" environment without actually privatising came from New Zealand. The electricity generation in that country was corporatised in the early 1990s. However, privatisation was however politically difficult; hence, the government decided to simply create a second SOE and put these companies in competition with each other while at the same time allowing for some private entry into the sector. In 1998, the government further split the generation industry into 4 SOEs. In addition, the possibility for non-commercial interference in the corporate governance by the shareholding minister (the Treasurer) was strictly limited (Wilson 1997). The SOEs were "ring -fenced", i.e. they were prohibited from engaging in other non-core activities, or in any form of cross-subsidisation while their financial structure was heavy on private debt. Debt holders were expected to fulfil a corporate governance/monitoring role, in the absence of private equity that could freely enter and exit in response to the firms' commercial performance. Most importantly, an independent regulator was created to protect consumer welfare.

While it is too early to judge the success of the New Zealand approach, one could envisage two potential problems:

(i) If private sector entry does occur, as has been the case in New Zealand in both generation and retail (transmission is still a monopoly), the SOEs are in a disadvantaged position. The financial structure of the SOEs is not flexible enough to allow expansion, in a world increasingly dominated by aggressive international companies. That is why the SOEs are now pushing for their privatisation and the government has initiated "scoping" studies for their possible sale.

(ii) The SOE debt might be perceived as government debt and a moral hazard situation develops; this may be the case in some countries with a long history of SOE bailouts. If this happens, private competitors will not enter the market as they will be facing a much higher cost of capital (and de novo entry in an infrastructure industry is extremely capital-intensive).

Finland and, to a degree, Sweden adopted a similar sequencing pattern in their telecom reforms. They introduced genuine competition at all levels (including fixed-line telephony) early on; and the state showed the unusual virtue of consistently maintaining an arm's length relationship with its company(ies), thereby nourishing a level playing field. In the case of Sonnera, the Finnish telecoms company, half of its revenue before privatisation was derived from mobile telephony, an intensely competitive sector while it faced competition in most local fixed line markets, long before it was privatised. This resulted in a very successful IPO in November 1998; the offering was heavily oversubscribed in spite of awkward conditions in international equity markets.

New Zealand, again, followed a similarly cautious path with telecom privatisation and the sequencing of the introduction of competition (Wilson 1997). The government allowed for entry in most segments of the market in the three year period that intervened between the 1987 corporatisation and the 1990 privatisation of the company. This has brought substantial benefits to consumers without the state having to transfer ownership. Privatisation was mainly company - driven (as was in the Finnish case) and was largely due to the need for a broader corporate finance base for firms, in the face of increasing global competition.

The above experiences lead to two conclusions: first, countries with the institutional capacity and political maturity to allow for real commercialisation of SOEs may reap the benefits of competition before privatisation, thus minimising the risk of regulatory capture and the raising of entry barriers by private monopolists after privatisation. Secondly, these countries might have to allow for important foreign competition to the national state-owned incumbent. Privatisation is important for the development of the firms in question. Ownership matters not so much for efficiency reasons, but rather to put these companies on a level playing field with their private sector competitors in terms of access to capital markets .

b……during privatisation

Privatisation offers a unique opportunity to restructure and introduce competition. In order to introduce competition, it is imperative that the natural monopoly and competitive segments of the relevant industry be effectively separated. Should the actual break up prove unfeasible, it is necessary to at least ensure that there is an accounting and organisational separation of these activities. An incumbent that is permitted to operate in both competitive and natural monopoly components of the industry, is likely to engage in anti-competitive behaviour such as restricting access to its network, and using its dominant position in the monopoly segment to support predatory behaviour in the competitive segments. In the UK rail and electricity privatisation as well as in the New Zealand electricity restructuring, the natural monopoly segments of the rail infrastructure and transmission grid were either kept under state ownership (in the case of New Zealand) or were separately floated (as in the case of UK) with the regulator being given the express mandate to prevent capture of the "grid" company by upstream or downstream commercial interests.

Restructuring the sector by breaking up vertically integrated monopolies has been employed by several countries starting in the late 1980s, in order to introduce and encourage competition in upstream or downstream markets. In most cases, competition seems to have developed and the impact on prices and services has been very positive. On the other hand, such a radical upsetting of the industrial landscape might be controversial and less consensual from a political perspective as it is bound to challenge a lot of vested interests.

The restructuring of the communications sector is a good example of the policy issues. In the past, many countries had their telecoms organisations integrated with postal services as part of the government. In the run up to telecom privatisation, most countries separated the two services in the context of corporatisation of the telecom carrier. This seems to have been a correct solution: telecom privatisation is far more palatable politically than post privatisation, even though postal services are becoming a competitive industry. The UK case is telling: H.M. Post is the last firm of any commercial consequence to remain under state ownership. This is mainly due to the largely misplaced fears about the availability of universal postal services. On the other hand, where such separation did not occur prior to privatisation (as in the case of Netherlands which privatised the holding company for these two businesses), subsequent attempts to separate the two businesses have met with problems and friction between the company and the regulator.

Universal service concerns have often been cited as an obstacle to privatisation. However, there is little evidence to support such worries. In the vast majority of cases, the availability of services has gotten much better with privatisation than it was under state ownership (Serra 1998, Holder 1998). Moreover, in many countries, with a strong universal or “public service” culture such as France and the Nordic countries, some basis public utilities have been for a long time provided by private agents (water and sewage in France and electricity in Finland and Norway). Yet, from a political perspective, there might be a need for explicit inclusion of relevant clauses in the mandate of the regulator and/or in the terms of license/franchise to industry participants.

There are some cases where the availability of services may be of real concern as it will depend on subsidies. In such cases using direct (reverse) bidding by potential entrants on the level of subsidies required would ensure that universal service concerns are met without major efficiency losses[21]. Nevertheless, practice indicates that rendering subsidies totally transparent may encounter serious political resistance as it impacts on the way power is exercised at a regional/local level. Incidentally, this is once more, an indication of how deeply privatisation can affect the role of the state and political customs.

To come back to the economic debate around competitive restructuring, an important concern is that the latter might destroy existing economies of scale. Where the markets are narrow and contestability is low, vertical unbundling might be more costly than living with an integrated firm with market power (Bacon 1994). While at times this might be the case, it seems better to err on the side of more competition. As the UK electricity industry experience shows, the market is quick in restructuring and consolidating itself in ways that are probably more efficient than existing vertical integration within SOEs (Jenkinson 1998). The freeing of infrastructure assets resulting form sectoral restructuring is one of the driving forces behind the emerging global utility companies; they are presumably better at achieving higher productive efficiency, have lower cost of capital and utilise global resources than protected national companies.

c……after privatisation

Competition and privatisation are sometimes uneasy policy bedfellows. Incumbent firms may argue successfully that the purpose of privatisation is to strengthen them, through a vastly increased possibility to tap international capital markets, so that they may become global players; that in view of intense global competition and or ongoing regional liberalisation they need to maintain their dominant position at home, by regulatory or other de facto obstacles; that maintaining the firm as such (i.e. avoiding any pre-privatisation restructuring of the hitherto monopoly) will create added gains for shareholders and thereby contribute to the development of the capital markets; and, most importantly, that there are still vast parts of their activities where a monopoly is still the "natural" outcome of the market.

Policy makers have to weigh these "company" arguments against the longer term goal of enhancing competition and maximising consumer welfare. Evidence suggests that in the initial stages of privatisation, they were far too sympathetic towards companies, preserving competitors rather than competition. Early UK privatisation in the 1980s as well as an important part of continental European utility privatisation during the 1990s kept the incumbents intact and preferred to privatise them as such -- often in parallel with a slow process of introducing competition after privatisation. UK telecoms and gas are good cases in point On the other hand, Italian[22] and French Telecom privatisation might be forgiven for not addressing directly competition issues as concerns, as the recent EU directives[23] have pressed liberalisation issues on EU member governments.

Applying structural remedies to a whole sector under diverse (mainly private) ownership arrangements ex-post could be very difficult from a legal/constitutional point of view and might prove to be an extremely long process[24]. In addition, private investors who bought into the government's privatisation drive will feel cheated and their reaction will impact on the future of the privatisation program, especially since these investors often include large parts of the population.

Delaying or rationing the introduction of competition after privatisation by tightly limiting entry does not seem to bear any positive results in the long run. Rationing of competition has resulted in an effective containment of the "junior" competitor in the market and the emergence of de facto oligopolistic co-ordination, as evidenced by the UK telecom experience. In the case of privatisation of British Telecom (BT) the government pursued a duopoly policy and placed restrictions on competition. This in effect maintained BT's monopoly character. On the contrary, ten years later, a more open regulatory environment in the case of German telecom privatisation has introduced vigorous competition at every level and has lowered prices in every segment of the telecom market[25].

Following privatisation, the regulator should remain alert to the capacity of incumbents with market power to generate efficiencies. Newbury and Pollitt (1997) have found that clear improvements in performance by UK electricity firms following the restructuring of the industry were largely appropriated by shareholders and managers -- with consumers seeing only a fraction of these benefits trickling down. This suggests that regulators underestimated the new companies' drive for cost cutting and the possibilities that they had to appropriate these gains, due to the slow pace of the liberalisation of the electricity retail market and information asymmetries with the regulator.

Making licensing requirements more complicated and raising other administrative hurdles, in addition to the presence of a large incumbent, might deter entry altogether as in the case of Japanese telecoms. On the other hand, there is some wisdom in designing an orderly opening of markets to competition *ex ante* (i.e. before privatisation takes place), and providing for a short timetable for transition[26].

A general concern with privatising big monopolies as such is that these companies will be "too big/important to fail". As a result of privatisation the state (and the tax payer) might become victims of a moral hazard situation. It might have to explicitly or implicitly guarantee the solvency of a private company, thus creating a lopsided playing field for investors and give the wrong incentives to company managers as regards to risk. The result is a continuing misallocation of financial and productive resources and a low level of financial discipline. In the presence of competition, these issues cease to be a problem (one firm's failure is not deemed to seriously endanger adequate provision as others will take its place). Where, on the contrary, a private monopoly replaces the state-owned one, moral hazard might intensify, in the absence of a carefully designed exit mechanism.

VI. Conclusions

Until recently, public utilities were considered to be natural monopolies, usually under state ownership, with universal access obligations and cross-subsidies built into their tariffs. The need to increase investment and to access capital in order to meet a growing and changing demand, in an era where the governments are faced with severe fiscal constraints, led to a fundamental change of course. The changing terms of production and industrial organisation resulting from rapid technological development and, last but not least, the hitherto unsatisfactory performance of state-owned utilities were important factors behind changing attitudes. *In response to these concerns, many countries have been introducing competition and privatising their public utilities, in order to improve productive and allocative efficiency, to increase investment and benefits to consumers and the economy as a whole.*

Utilities and infrastructure are highly idiosyncratic and sensitive sectors of the economy. In contrast to the tradables sector, where a general regulatory legal framework for the protection of competition and consumers is sufficient, the provision of essential infrastructure services retains an important public interest component, both because it might remain monopolistic in certain respects and because of its pervasive importance as an input in all other businesses and households. Liberalisation and reform in the OECD countries have revolved around one fundamental precept: *the separation of commercial from public interest objectives and their assignment to different institutions*. On the public interest side, a new breed of regulatory institutions have sprung up that are there to police the monopoly segments of the infrastructure markets and to promote the introduction of competition where that is possible.

In this respect, privatisation is an effective policy tool. It provides suppliers with profit oriented incentive structures and access to capital markets. It is the policy which addresses the *subjective side of market development*: you need private players to have markets. The introduction of competition is the other, equally important policy tool for commercialisation of infrastructure. It provides for the necessary rules of the game, the *objective for market development*. It helps ensure that efficiency improvements at the firm level are translated into lower prices for the consumers and a more efficient allocation of resources in the economy as a whole.

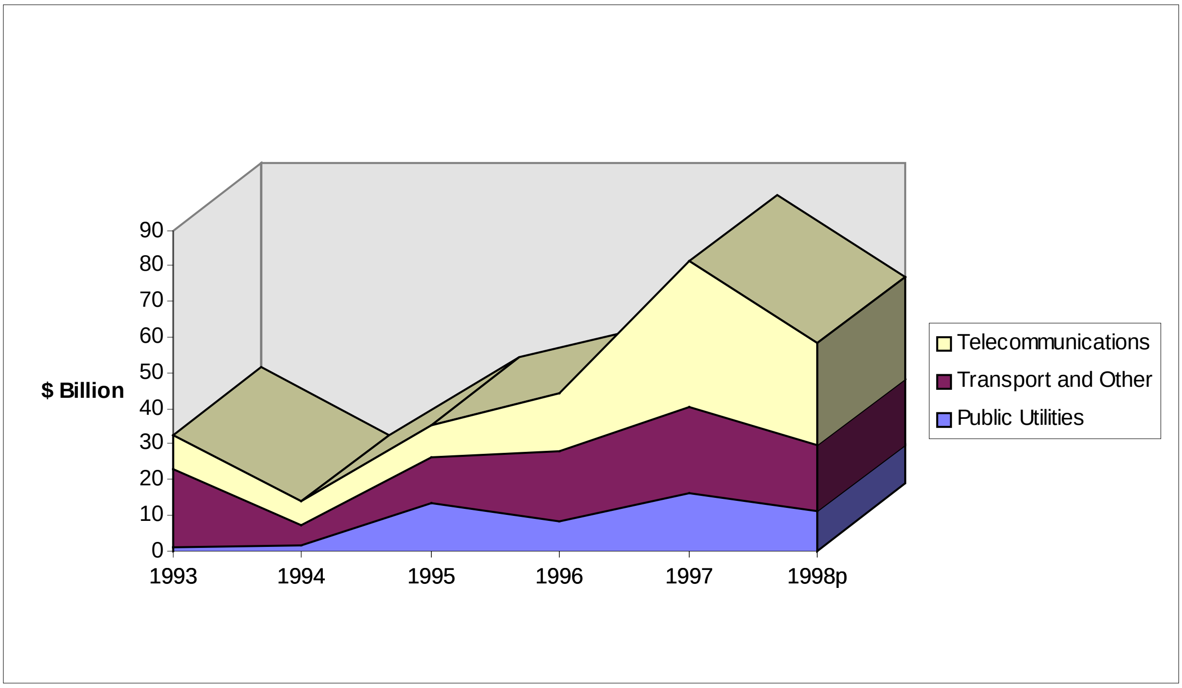
There have been arguments about whether a government can use one of these tools without the other. Privatising large monopolies, even with an adequate regulatory framework, might yield important efficiency gains at the firm level but from a public choice perspective it will tend to benefit certain groups (i.e. shareholders and management -- and possibly the state as a tax collector), at the expense of consumers and employees. On the other hand, competition without privatisation, might prove to be elusive in the long term. When private firms compete with SOEs, the latter are either favoured because they are state-owned (that would be the case in most institutional environments) or are in a disadvantaged position because of their limited access to capital. Competition between state-owned firms exclusively might be an extremely difficult game to introduce --almost a contradiction on itself; and it might prove to be very inefficient as its financing is exclusively debt-oriented. *It follows that privatisation and competition need to be pursued in tandem.* The choice is about sequencing rather than the exclusive use of one or the other tool.

Privatisation has had positive results in almost all of the OECD countries that have undertaken it.

Empirical research seems to suggest that important efficiencies were generated by the change in incentives, financing and governance structures that privatisation generates. Moreover, privatisation creates important positive spillovers in the economy that are often ignored by empirical researchers. These include new performance benchmarks for remaining State-Owned Enterprises (SOEs). The "equilibrium of inefficiency", faced by many countries in their public sectors, is upset and important incentives are created for better performance even before privatisation. Insider expectations as to the future of the company (and of themselves) radically change and a competitive market for managers emerges, even within the public sector (Douglas 1996). A robust and credible privatisation program thus delivers a lot of its benefits before the actual sale of a company. Even companies that are not programmed for sale are subject to increased corporate governance rigor as the state has fewer firms to police and its outlook on what commercial entities should be doing is changing.

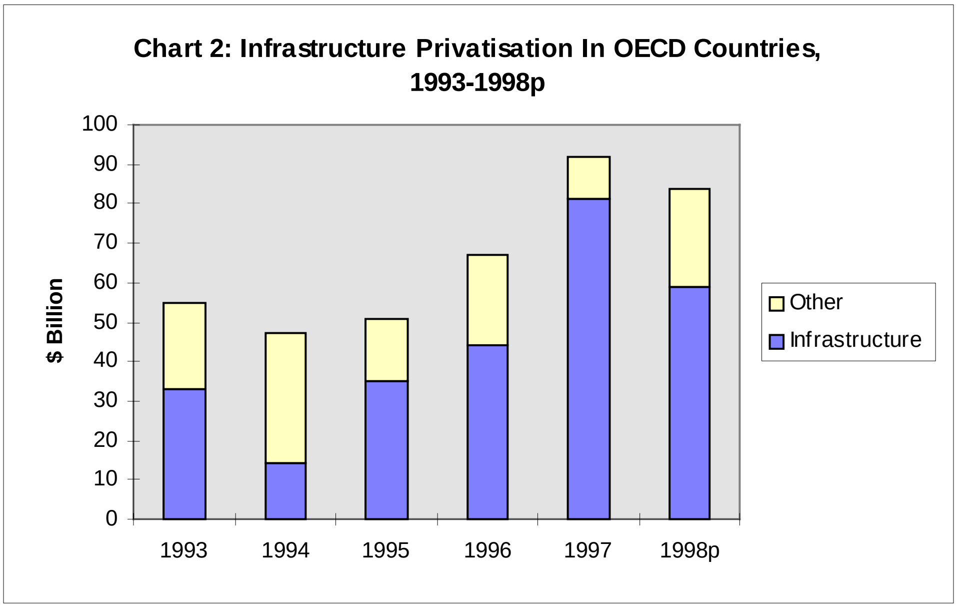
Finally, privatisation has changed the enterprises involved with a speed and depth never observed before. Access to international capital markets has created several global, competitive companies out of hitherto inefficient state monopolies. This, in turn has increased the momentum for globalisation in infrastructure industries and has put further pressure on laggards to privatise and allow for competition.

Chart 1: Utility Privatisations in OECD, 1993 - 1998p

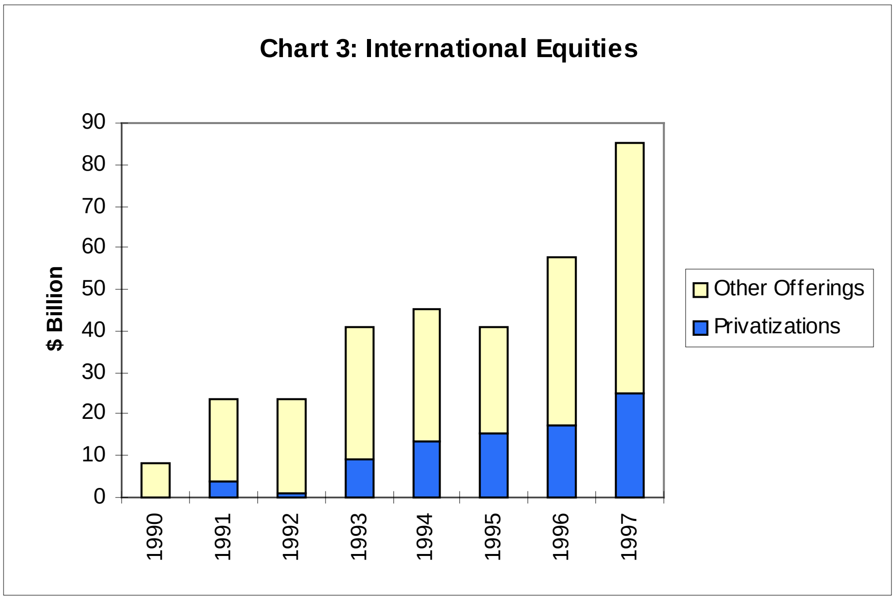


(*) Public utilities includes electricity, gas and water supply

Source: OECD, Financial Market Trends

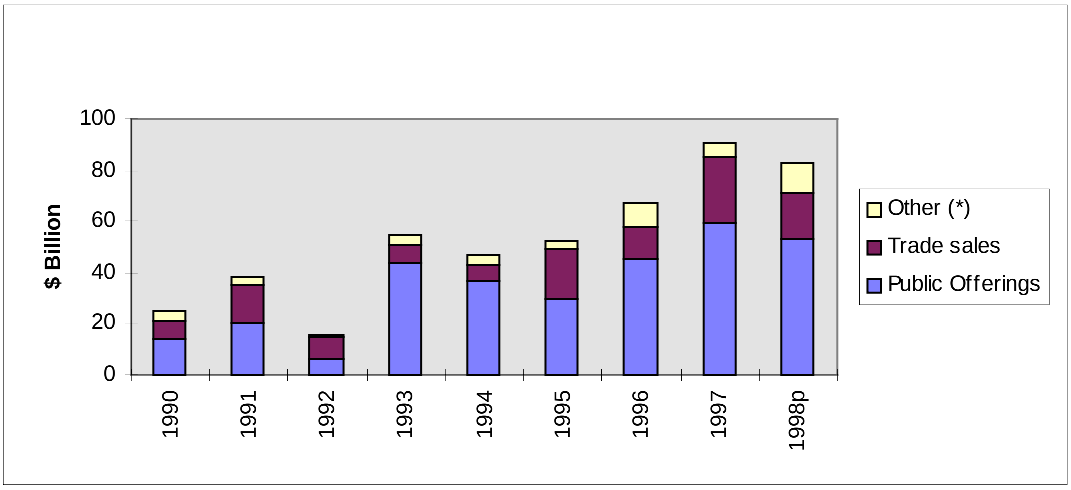


Source: OECD, Financial Market Trends



Source: OECD, Financial Market Trends

Chart 4: Distribution Of OECD Privatisations By Method of Sale



Source: OECD, Financial Market Trends

Selected Bibliography

Alchian, Armen and Harold Demsetz. (1972), "Production, Information Costs And Economic Organisation", *American Economic Review*, 62 , 777-795.

Bacon, R. (1994), "Lesson From The Electricity Sector Reform In England And Wales", *Public Policy For Private Sector*, The World Bank.

Beesley, Michael and Stephen Littlechild. (1994), "Privatisation: Principles, Problems, And Priorities", in Bishop, Kay, and Mayer (eds.), "*Privatisation & Economic Performance*", Oxford University Press.

Bitran, Eduardo and Pablo Serra. (1997), "Regulation Of Privatised Utilities: Lessons From The Chilean Experience", in OECD, "*Privatisation Of Utilities And Infrastructure*".

Boycko, Maxim, R.. Schleifer, and. R.. Vishny. (1996), "A Theory Of Privatisation", *The Economic Journal* 106, 309-319.

Brumby, Jim and. S. Hyndman. (1998), "State-Owned Enterprise Governance: Focus On Economic Efficiency", in OECD, "*Corporate Governance, State-Owned Enterprises And Privatisation*".

Ciucci, Pietro. (1998), "The Italian Privatisation Experience And The Role Of IRI", paper presented at the conference on Privatisation in Europe, Mimeo.

Douglas, Roger. (1996), "The Role Of Government In The Economy", in OECD "*Privatisation In Europe , Asia And Latin America"*.

Estrin, Saul. (1998), "State Ownership, Corporate Governance And Privatisation", in OECD, "*Corporate Governance, State-owned Enterprises And Privatisation"*.

Galal et al (eds). (1994), "*The Welfare Consequences Of Selling Public Enteprises: An Empirical Analysis*", New York, Oxford University Press.

Grilli, Vittorio. (1997), "Privatisation In Italy" presentation at the OECD Privatisation Network meeting (Mimeo).

Guislain, Pierre. (1997), "*The Privatisation Challenge*", The World Bank.

Helm Dieter, and Tim Jenkinson. (1997), "The Assessment: Introducing Competition Into Regulated Industries", *Oxford Review Of Economic Policy*, Vol. 13, No. 1.

Holder, Stewart. (1998), "Privatisation and Competition: The Evidence From Utility And Infrastructure Privatisation In The UK", in OECD, "*Privatisation, Competition And Regulation*", 1999 --forthcoming.

Jasinski, Pyotr and. George Yarrow. (1995), "Privatisation: An Overview Of The Issues", *Studies in Regulation*, No 4 Regulatory Policy Institute, Oxford.

Jenkinson, Tim. (1998), "Corporate Governance And Privatisation Via Initial Public Offering", in OECD "*Corporate Governance, State-Owned enterprises And Privatisation*".

Jensen, Michael. (1986), “Agency Costs And Free Cash Flow”, *American Economic Review*,76, 306-360

La Porta, Rafael and F. Lopez de-Silaez. (1997), “Benefits Of Privatisation - Evidence From Mexico”, “*Public Policy For The Private Sector”*, Quarterly No. 10, June, World Bank.

Ludwig, F. M. (1996), “The Case Of The German Railroads” in World Bank “*Corporate Governance and Public Enterprises in Transition Economies*”, Technical Papers, Number 323.

Megginson, William and. R..C Nash, and M. and M. Van Randenborgh. (1994), “The Privatisation Dividend - A World-Wide Analysis Of The Financial On Operating Performance Of Newly Privatised Firms”, *Journal of Finance 49, 2.*

Moore, Jim. (1986), “Why Privatise” in John Kay, Colin Mayer and David Thompson “*Privatisation and Regulation- the U.K. Experience*” Clarendon Press.

Morin, François. (1998), “The Privatisation Process And Corporate Governance: The French Case” in OECD “*Corporate Governance, State-owned Enterprises And Privatisation*”.

Newbery, David M. (1997), “Privatisation and liberalisation of Network Utilities”, *European Economic Review*, 41, 357-383 .

Newbery, David M. and M.G. Pollitt. (1997), “The Restructuring And Privatisation Of The CEGB- Was It Worth It?”, *Journal of Industrial Economics*, XLV(3), 269-303

National Economic Research Associates. (1996), “*Performance Of Privatised Industries: A Report By NERA For The Centre For Policy Studies*”, Volume 3: Efficiency.

Nellis, John. (1991), “ Contract Plans: A Review Of International Experience”, in Ravi Ramamurti and Raymond Vernon (eds) “*Privatisation And Control Of State-Owned Enterprises*”, EDI Studies.

Nestor, Stilpon. (1998), “Privatisation in the OECD Area” in Petros Mavroidis and Cottier T. (eds) “*State Trading In The Twenty First Century*”, Michigan University Press.

Nestor, Stilpon and M. Nigon. (1996), “Privatisation In Europe, Asia And Latin America: What Lessons Can Be Drawn?” in OECD “ *Privatisation In Europe, Asia And Latin America*”

Nestor, Stilpon and John Thompson. (1999), “Corporate Governance Patterns In The OECD Area: Is Convergance Under Way?”, paper presented at the OECD/KDI meeting on “Corporate governance In Asia: a Comaprative Perspective”.

Pebble, Richard William. (1996), “Corporatisation Of Public Enterprise In New Zealand” in World Bank “*Corporate Governance And Public Enterprises In Transition Economies*”, technical papers number 323.

Privatisation International (1999), January, 4-6.

OECD, (1998), “Recent Privatisation Trends” in OECD, *Financial Market Trends* , No. 70

OECD, (1999), “Recent Privatisation Trends” in OECD, *Financial Market Trends* , No. 72

Roscini, Dante and M. Esteve. (1998), “Evolution Of European Equity Market Issuance” *in Privatisation International* , December 1998.

Serra, Pablo. (1998), “Evidence From Utility And Infrastructure Privatisation In Chile” in OECD, “*Privatisation, Competition And Regulation*”, 1999 --forthcoming.

Schmidt Klaus. (1996), “The Costs And Benefits Of Privatisation: An Incomplete Contracts Approach” in *The Journal Of Law, Economics And Organisation* 12.

Shirley, Mary. (1997), “Information, Incentives And Commitment: An Empirical Analysis Of Contracts Between Governments And State-Owned Enterprises”, World Bank Policy Research paper 1769.

Stiglitz, Joseph. (1993), “On The Economic Role Of The State” in J. Stiglitz et al. “*The Economic Role of the State*”, B. Blackwell .

U.K Treasury (1996), “Privatisation In The United Kingdom”, in OECD, “*Privatisation In Europe, Asia And Latin America*”.

Valverde, Rafael. (1998), “The Portuguese Experience”, paper presented at the conference on Privatisation in Portugal and Italy, Mimeo.

Vickers, John and George Yarrow. (1988), “*Privatisation: An Economic Analysis*”, MIT Press

Wilson, John. (1997), “Restructuring The New Zealand Electricity Industry”, OECD, “*Privatisation Of Utilities And Infrastructure*”.

Notes

[1] See Financial Market Trends (FMT), OECD, Number 72.

[2] Privatisation has been the main cause of the quadrupling of the capitalization of some European exchanges (Milan, Lisbon) in recent years. See Ciucci (98) and Valverde (98).

[3] These restrictions formed until recently a major part of individual country reservations under the OECD Codes of Capital Movements and invisible transactions, designed to eliminate discrimination and obstacles to capital flows between Member countries.

[4] Economist, January 23, 1999, based on 1998 KPMG report on Mergers and Acquisitions.

[5] In Germany , the Basic Law had to be amended in order to allow for the privatisation of telecommunications. Mexico had to go through several constitutional amendments in the 1980s to allow for the privatisation of certain "sensitive" sectors of the economy. More importantly, the Portuguese constitution had to be changed in 1989, to allow for the privatisation of more than 49% of all nationalized firms (Nestor and Nigon 1996).

[6] See Galal et al

[7] It has been pointed out that structural adjustment would have led to closures and unemployment in these sectors irrespective of the ownership regime; and that what is really needed is active labour market policies and an adequate social safety net for both public and private sector workers in these industries see (World Development Report 96).

[8] For a revue of the considerable literature on the principal agent problem in the context of state ownership see Estrin (1998).

[9] This is of course an over-simplification of the real reasons for nationalizing network industries. In many cases, this was an ideological decision that did not even claim an economic rationale.

[10] Italy and Spain consistently topped the OECD privatisation league during the last few years; other EMU countries are also showing impressive performances (OECD, FMT No: 67, 70 and 72).

[11] See Schmidt 1996, who alludes to these issues, without directly addressing them.

[12] While framework contracts were pioneered and perfected mainly in French SOEs, other countries used similar devices such as the shareholder statement of expectations in New Zealand (see Nellis 1991 and Brumby/Hyndman 1998)

[13] In many OECD member countries, partial privatisation has been undertaken as a strategy of gradual introduction of a company in the stock market, for reasons related to the perceived absorption capacity of the latter. That has been the case in many British companies (BT, Britgaz), Spanish (Telefonica, Argentaria) and Italian (ENI, Telecom Italia). In other cases, however, partial privatisation has been the final objective: Deutche Telecom, France Telecom and Royal KPN of the Netherlands have been only partially floated with the state intending to remain a controlling shareholder; some of the smaller OECD economies have kept large stakes of their utilities (telecoms in Czech Republic and electricity in Belgium), after having sold important minority stakes to strategic foreign investors.

[14] It should be noted that their sample includes firms from developing countries as well as OECD ones.

[15] Includes all privatised companies to that date, and not just public utilities. However, the latter account for the bulk of these financial inflows.

[16] In part IV of this paper, we review some of the main issues for the introduction of competition.

[17] See also the discussion on introducing competition below.

[18] UK: (Holder, 1998), and for Chile: (Serra, 1998).

[19] This is evident in the case of U.K. privatisation. See U.K. Treasury 1996.

[20] In the case of the purchase of the Czech airline CSA by Air France in the early 1990s, the sale had to be reversed due to the inability of the buyer to proceed with the needed reforms and capital infusions; the same was true with the acquisition of part of the Hungarian airline MATAV by Alitalia. In the case of the Spanish Telefonica acquiring a dominant position in the Chilean telecoms market, Serra(1998) notes that Telefonica was quite successful in resisting regulatory pressure for more competition, a fact that might be related to its state owned status, until recently.

[21] In this case there is competition in acquiring the rights to provide the service , rather than competition in the provision of service. This approach has been used in Chile for increasing access to telephone service in remote and poor rural areas.

[22] However, in case of ENEL, the Italian state-owned electricity company the Prime Minister, has been quoted as saying that privatisation would only be considered after liberalization and creation of real competition.

[23] For example, European Union, DG XVII , IEM directive 96/92 deals with electricity, and requires member states to open up at least 26.48% of their natural markets to free competition, as of Feb 1999. For Telecom See ONP Framework Directive, section III.A.6 where member states are required to liberalise public voice telephony by January 1998, while maintaining universal service.

[24] See the experience with the implementation of structural remedies in the US, in an antitrust context: the break up of “Ma Bell” took more than ten years, while other antitrust suits that focused on structural remedies have often failed after protracted legal battle (for example the IBM case of in the 70s).

[25] See the Economist 12/12/98 .

[26] For example, outside OECD, Brazil seems to have adopted this approach.