FOREWORD

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This book brings together a set of essays on recent experiences and current thinking in the debate over privatization, the conversion of state-owned assets into privately managed assets. Especially after Ronald Reagan and Margaret Thatcher assumed office in the United States and the United Kingdom, a conventional wisdom developed that private management and ownership was better, in some sense, than public ownership and management: enterprises would be run more efficiently and there would be less opportunity for corruption. The World Bank and the International Monetary Fund (IMF) pushed countries to privatize as much as they could and as fast as they could. Privatization became not only one of the pillars of the “Washington Consensus” but also a condition imposed on countries seeking assistance.

The experiences of the last 15 years have cast a pallor over this unbridled enthusiasm for privatization. As these essays illustrate, a new, more pragmatic consensus is developing—more consistent with economists’ normal two-handed stance, “it depends.” Privatization has had some successes, but it has also been marked by dramatic failures and disappointments. There are dramatic successes, and failures, in state ownership. The questions being posed today are: When will privatization be successful? And how can the privatization process be managed to maximize the likelihood of success?

Perhaps no subject in development arouses more passions—on both sides—than privatization. The privatization process has been marked by enormous abuses: in many countries a few individuals managed to grab hold of previously state-owned resources for a pittance and become millionaires—or billionaires. In a few years, Russia became a country marked by great inequality, with a Gini coefficient as bad as many in Latin
America. By some estimates, $1.5 trillion in assets were stolen. While Russian became a language commonly spoken in the most fashionable resorts around the world, Russia’s pensioners were becoming increasingly impoverished, its educational system, once one of the finest in the world, was decaying, and the Russian economy was declining. Life expectancy was decreasing, while elsewhere (outside of those African countries afflicted with AIDS) it was on the rise.1

Elsewhere, I have explained why these results should not have been unexpected.2 Critics of state-owned enterprises (SOEs) argued that they were subject to corruption; that is, that government officials responsible for managing them often did not act in the interests of those they were supposed to be serving (i.e., the public). This is an example of a classic principal-agent problem. But there is an even more serious principal-agent problem in the privatization process itself. What is at stake is not just the current flow of profits (rents), but the present discounted value of these rents, which is much larger. It follows that incentives for abuse are all the greater. Moreover, there are a variety of ways by which the extent of abuse in the running of SOEs can be monitored and controlled (e.g., by benchmarking), but experience suggests that it may be more difficult to control abuses within the privatization process. Standard remedies have focused on the use of auction processes, but in Russia and elsewhere it became clear that there is ample scope for auctions to be rigged by setting the rules (including “qualifying” bidders).

Other failures of privatization arose when monopolies (especially natural monopolies) were privatized before regulatory and antitrust systems were put into place. The private sector was better at exploiting monopoly power than the government: overall economic efficiency was not enhanced. Monopoly in Mexico’s telecommunications sector, the result of a poorly designed privatization, has helped create one of the richest men in the world. High telephone prices, however—a multiple of those in India—have not helped Mexico’s development.

But while privatization has deservedly had its critics, so have SOEs. Many have not been run efficiently, and many have created losses that have been a burden on the state—money that could have been used for education or to pursue other developmental objectives. There are instances of corruption. Even advocates of state ownership, like Greece’s socialist prime minister, Andrea Papandreou, talked of the challenges of “socializing” the SOEs,3 making them act in ways that were consistent with social objectives, not just the interests of their managers and workers.
It would be easy to suggest that, after all, it was these abuses that motivated the privatization agenda; but that would be incorrect. Privatization has been pushed even when state-run enterprises have been highly efficient. The IMF pushed Korea to privatize its state-run steel company, which was markedly more efficient than many of the privately run steel companies in the United States. U.S. Republicans pushed for privatization of the social security (pension) program, even though its transaction costs were far lower than those in any private sector firm. In Europe, there was a push for privatization of France’s state-run electricity company, even though there was little prospect that a privately run firm would lower costs or increase quality (reliability).

One of the reasons for the drive for privatization is simple-minded ideology—and one of the objectives of the Initiative for Policy Dialogue (IPD) at Columbia University is to expose these ideological biases, ungrounded in theory or empirical evidence. But another of the motivations for the drive for privatization is special interests (greed): even an inefficient privatization process can generate large wealth for a few. Financial markets in the United States looked with hopeful anticipation at the commissions that they would earn from managing the trillions of dollars in the social security system. While pensioners may lose from increased transactions costs, Wall Street would gain.

\section*{Economic Theory}

Simpleminded economic theory suggested that private ownership should be better than state-run enterprises. After all, private ownership provided incentives that were missing under state ownership. Many years ago, Nobel Prize winner Herbert Simon explained what was wrong with this reasoning: few large modern firms are run by owners; there is, in modern parlance, a principal-agent problem. But there is little difference between this principal-agent problem and that facing the government, trying to motivate those entrusted to manage SOEs.

Actually, the flaws in the simplistic reasoning go deeper. The simplistic reasoning is predicated on three hypotheses: (1) profit maximizing (stock market value maximizing) behavior on the part of the firm leads to Pareto efficiency; (2) all shareholders will want the firm to maximize market value; and (3) competitive markets ensure that firms act in a profit-maximizing way; if a firm does not maximize profits, it will be taken over. Someone will buy the firm and change the firm’s strategy, and will thereby reap a capital
gain. None of these hypotheses is, in fact, correct under general conditions (e.g., when there is imperfect information or incomplete risk markets).

The first hypothesis is, of course, simply Adam Smith’s invisible hand conjecture: Arrow and Debreu (1954) showed that it was correct, but only under highly restrictive conditions. Subsequently, Greenwald and Stiglitz (1986) showed that whenever information is imperfect or markets are incomplete, markets are not in general constrained Pareto efficient (i.e., even taking into account that information is costly and that there are transaction costs). Shareholder maximization in particular did not result in (Pareto) efficiency. Grossman and Stiglitz (1980) showed that in the absence of a complete set of securities (markets), different shareholders might want the firm to pursue different objectives. For instance, some might want the firm to maximize stock market value today, but others (especially shareholders who are planning to hold onto the shares for a long time) might argue that most stock market investors are shortsighted and that the firm should focus on long-run profits.

Finally, the takeover mechanism is far from perfect—and it is in managers’ interest to keep it that way. They can create information asymmetries and other barriers to takeover. There is ample evidence that firms can and do pursue policies (over extended periods of time) that are not value maximizing.

As an almost immediate corollary of these results, Sappington and Stiglitz (1987) showed that the only conditions under which privatization could be guaranteed to be an effective way of implementing social objectives are precisely the same conditions under which markets are Pareto efficient: there can be no market failures—including no information asymmetries or other market imperfections of the kind discussed by Greenwald and Stiglitz.

In short, the theoretical case for privatization is, at best, weak or nonexistent. It is strongest in the areas in which there is by now a broad consensus—areas like steel or textiles, conventional commodities in which market failures may be more limited. But by the same token, these are precisely the sectors in which abuses can most easily be controlled, appropriate incentives can best be designed, and benchmarks against other firms can most easily be set.

**EXAMPLES**

In other areas, there are many examples illustrating the difficulties in designing appropriate incentives for private sector owners to act in society’s
interests. For instance, America’s partial privatization of the army—the use of contractors—has not only been extraordinarily expensive, but in many ways it has also proven counterproductive. The contractors have focused on minimizing costs, not on “winning the hearts and minds” of the Iraqis, an objective that was impossible to translate into financial incentives. At the early stages of the Iraq war, when Iraqi unemployment hit 60%, it was important to create employment, but cost minimization by the contractors induced them to bring in workers from Nepal and the Philippines.

Or consider the problems of managing airports. The private owners’ profits are derived today largely from commissions on sales at airport stores. The longer individuals spend at the airport, the more the profits are increased. Randomness in security checks—making it necessary for individuals to arrive early to ensure that they catch their planes—is, to the owners, a benefit, even if to both passengers and the airlines it is a huge cost. Their incentives are not well aligned.

Recent anxiety over sovereign funds (funds owned by foreign governments) highlights the view even in liberal advanced industrial countries that ownership matters. These critics have explained why we should be worried about foreign owners, but not about domestic owners. For instance, the United States privatized the United States Enrichment Corporation (USEC), which is responsible for enriching uranium. Low-enriched uranium is used in nuclear power plants, highly enriched uranium is used in atomic bombs, and the same plant can produce either. A private owner’s incentive to sell the enriched uranium to the highest bidder is obviously not in the national interest of limiting nuclear proliferation. It would clearly be a concern to sell USEC to Iran or a foreign government interested in obtaining highly enriched uranium. But should it not equally be a concern to sell it to a private domestic firm?12

Not only are there many examples, like these, where private management has not worked well, but there are also many examples where public management has. I have already cited several (Korean steel, French electricity). There are others: Malaysia claims that its state-run oil company is able to deliver to its citizens a larger fraction of the value of that country’s natural resource than any private company could or would have. The incentive of a private oil company is to minimize what it pays the country from which it takes the resource. There is a natural conflict of interest: the objective of the country should be to maximize the amount the oil company pays. And unfortunately, it is difficult to design and
enforce contracts and competitive auction processes that minimize the rents paid to private oil companies. Oil companies have repeatedly tried to get advantageous contracts and, even after signing a contract, to cheat on what they pay—even with seemingly sophisticated governments like that of the state of Alaska.13

COMPARING PRIVATE AND PUBLIC MANAGEMENT

The fact that, on average, private firms seem more profitable than public firms does not necessarily mean that private firms are more efficient. The public firms may, for instance, face constraints that the private firms do not; the solution to the problem may not be privatization but changing the constraints. Most importantly, many public firms face tight investment constraints. This comes because many developing countries face tight budget constraints in which the IMF has artificially consolidated state-run enterprises with the rest of the government budget. (It does not do this, at least in the same way, for advanced industrial countries.) These budget constraints mean that there is underinvestment in state-run enterprises; the poor performance is a result of this underinvestment.

Moreover, many public firms are entrusted with distributional objectives. Everyone, no matter how poor, should have access to clean water. This may entail delivering water at below average cost—and even below marginal cost. There is a cross subsidy, but the “water tax” imposed on higher-income individuals may not be enough to offset the losses on the low-income individuals. By contrast, a private profit-maximizing water company will focus on those able to pay more. If there is a limit on the amount of treated water, it may not even supply water to the poor, and in any case, it will not deliver water to anyone at below marginal cost.

It is thus no surprise that water privatizations have been the subject of such controversy. While they have often been justified as providing the resources necessary for the investment to expand service to all, they have not been perceived as doing this.

LEGAL DISPUTES

Some governments, of course, have been worried about these distributional consequences of privatizations and have tried to mitigate the adverse reactions by imposing service requirements. In other cases, governments have demanded that an oil or gas company given a concession make certain
minimal investments. But because the incentives of the private firm are not aligned with those of government (or society), they work to circumvent these requirements, giving rise to legal disputes. In the case of the investment requirements, for instance, the foreign firms may use “transfer” pricing schemes—the firm complies at the made-up prices the firm uses (which may even include charges for the time of the corporation’s headquarter management). In other cases, the private firm may claim that the government did not comply with implicit or explicit provisions of the concession requirement; for instance, in Bolivia, some of the oil and gas companies claimed that they could not make the necessary investments because of the civil unrest in the country.

When there is actual or suspected bribery in the granting of a concession or in a privatization (suspected because the terms are so unfavorable to the country that it is hard to believe that they are simply a matter of incompetence), successor governments may be under political pressure to rectify the agreement. In some cases, they may have firm legal grounds; for instance, the agreement may not have satisfied certain constitutional provisions.¹⁴

No contract is ever complete.¹⁵ Governments always have the power to impose regulations or undertake other actions that work to the disadvantage of the private firm. They may impose or enforce tougher environmental laws. If the government has a monopoly on electricity, it can fail to provide electricity on a regular basis, or it can demand higher prices. In short, there is always some leverage to force a renegotiation. More powerful governments, like Russia’s, have used that power.

In recent years, many countries have signed bilateral investment agreements that provide for arbitration of these state-investor disputes. But these investment agreements have themselves provided a further argument against privatization. They are conducted by judicial processes that fall far short of the judicial standards expected in modern democracies (e.g., proceedings, and even the rulings, may be secret; there is no appellate process and no clear system of determining precedents).¹⁶

**THE PRIVATIZATION PROCESS**

Even if it could be shown that private ownership is more efficient than public ownership, it does not follow that privatization is desirable, for a simple reason: it is very difficult to do privatization well. Of obvious concern is the loss of revenue to the government in the process of
privatization; also of concern are the resulting inequality and the undermining of confidence in the market system itself (as well as in democratic political processes). For markets to work well, there must be confidence in the legitimacy of property. If there is a widespread belief that those with wealth have obtained their wealth illegitimately, then there will be pressures for renationalization, or recapturing in some other way wealth that is viewed as having been stolen from society. But if investors believe that there is a significant risk of recapture (either through taxes or some other mechanism), incentives for investing will be attenuated, and incentives for asset stripping will be increased. But that, in turn, will mean that society will not reap many of the benefits that advocates of privatization promise; and as that happens, support for privatization and the market will wane.

**NEGATIVE LUMP-SUM TAXES**

There is a further problem when privatization occurs in ways that do not maximize government revenues, e.g., in voucher privatizations, in which state wealth is basically given back to citizens. It is equivalent to a negative lump-sum tax.

Governments need money to function, and most revenues are raised through distortionary taxation. Had the government continued to own the assets (assuming that it managed them reasonably well), they would have generated income that would have reduced the need for governments to raise distortionary taxes. Privatization results in the necessity of government to impose more distortionary taxation in the future, reducing the economy’s efficiency.

**SEQUENCING**

Earlier I raised the concern that often privatization has occurred before the appropriate regulatory structure has been put into place. Privatization advocates have urged rapid privatization even before good legal frameworks are put into place, arguing that privatization would create a constituency in favor of the rule of law.17 This has not turned out to be the case; in fact, there was neither theory nor historical experience in support of this view. On the contrary, once a monopoly has been privatized, it is in the interests of the monopolist to do what he can to maintain that monopoly—and that means using some of his profits to “invest” in the
political process to ensure that his monopoly is maintained. By the same
token, those who have excelled at stripping assets out of the firm, taking
advantage of the lack of good corporate governance laws, have often not
been part of the constituency for the establishment of the rule of law. On
the contrary, they have benefited from the lack of good corporate gover-
nance laws, and they have especially benefited under the regime of capital
market liberalization, which has meant that they could strip assets, take
their money abroad, and enjoy strong property rights protection there,
even as they abuse the property rights of others at home.\textsuperscript{18}

Privatization is a more complex subject than simple ideologues—including
the advocates of the Washington Consensus—thought a decade ago. The
theoretical presumption is, at best, much weaker than they thought. At the
same time, the theoretical and practical problems in privatization are
greater than they thought.

There have been major government failures, and it is these that have
contributed to the demand for privatization. But there have also been ma-
jor market failures, especially in areas where market and social incentives
may markedly differ. And in these areas, ensuring that the private sector
acts in accordance with social needs and desires may not be easy.

\textbf{NOTES}

1. For a discussion of these experiences, see, for instance, Stiglitz (1991b, 2000a,
2000b) and Ellerman and Stiglitz (2001).
3. In personal conversations in 1983, not long after he assumed office.
4. See Orszag and Stiglitz (2001) and references cited there.
6. Earlier, Berle and Means (1932) referred to the split between ownership and
control. This has given rise to the general problem of corporate governance. See, e.g.,
7. For a more extensive discussion of these theoretical issues, see Stiglitz (1991a,
1995).
12. Indeed, the lack of coincidence of interests became clear, as USEC worked hard
to keep out of the market the de-enriched warheads of deactivated Russian warheads;
even though doing so had obvious risks for nuclear proliferation. See Stiglitz (2002).
14. For instance, many constitutions (such as Mexico’s) do not allow the sale of a country’s national resources; others (such as Bolivia’s) allow the sale of certain resources only after ratification by the legislature. In the case of Bolivia, questions were raised about whether certain privatizations/concessions conformed to this constitutional provision.
15. The recognition of the impossibility of complete contracts—and the consequences of this—is one of the important advances of modern economic theory.
16. Elsewhere, I have written at length concerning the deficiencies of these agreements. See Stiglitz (forthcoming).
18. See Hoff and Stiglitz (2004, forthcoming). The disappointments with the privatizations in Russia and elsewhere in the economies in transition has led to a large literature trying to explain the factors that contribute to a successful transition and a successful privatization. Godoy and Stiglitz (2007) argue that privatization played a far less important role than did the underlying institutional reforms. Stiglitz (2000a) argues, in particular, that the lack of good corporate governance meant that there were greater incentives for asset stripping and wealth creation; while Hoff and Stiglitz (2004, forthcoming) argue that the way privatization was conducted actually undermined the creation of a rule of law.

REFERENCES


