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Privatization, Social Impact, and Social Safety Nets

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Abstract

Privatization promotes economic efficiency and growth, thereby reinforcing macroeconomic adjustment. In the short run, however, it can lead to job losses and wage cuts for workers and higher prices for consumers. This paper discusses these impacts and the fiscal implications of privatization. It then reviews various methods of privatization and finds that public sales and auctions can have more negative effects on workers but maximize the government's revenue gains. Policymakers' options for mitigating the social impact of privatization are surveyed, and experiences under adjustment programs reviewed.

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Contents

I. INTRODUCTION

Economic adjustment programs employ a range of macroeconomic policies to correct domestic and external imbalances and to create conditions for growth in a stable macroeconomic environment. The macroeconomic policies are complemented by structural reforms that seek to make macroeconomic adjustment more durable and to improve its quality.

The restructuring and privatization of state enterprises is one of the many structural reforms found in adjustment programs. (Other reforms typically focus on tax systems and tax administration, price liberalization, the financial sector, and trade liberalization.) State enterprises, especially in developing countries, tend to be overstaffed, pay excessive wages, and have low productivity (Kikeri, 1997). Consequently, these enterprises are often a drain on the budget and a drag on economic growth.

Privatization, along with other structural reforms, has therefore been seen as promoting economic efficiency and growth. However, some structural reforms can have an adverse social impact, at least in the short run. For instance, privatization can be associated with job losses and wage cuts for workers, and higher prices for consumers. In this context, the IMF's policy advice has increasingly sought to address these and similar concerns in programs it supports.[2] As a result, many IMF-supported programs have incorporated cost-effective social safety nets to protect the vulnerable during the adjustment period and maintain their access to basic public services.[3] [4]

The basic purpose of social safety nets is to mitigate the short-term adverse effects of macroeconomic and structural policies on the consumption of the vulnerable. Protection mechanisms have taken many forms, including the targeting of subsidies to those who face large cuts in real income, the provision of severance payments and temporary employment to job losers, and the adapting of existing social security arrangements.[5] The design of social safety nets is expected to take into account the composition of affected population groups; the potential effects of policy-reform measures; and financial, political, and administrative constraints.[6] [7]

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[2] Restructuring and privatization of state enterprises involves many complex issues, and much of the technical analysis incorporated in IMF-supported programs is typically undertaken by other organizations, such as the World Bank and regional development banks, as well as bilateral donors.

[3] See Chu and Gupta (1998), for a survey of issues and experiences with social safety nets.

[4] As a general principle, adjustment programs should, where possible, be designed to minimize negative social effects. Therefore, it is important to explore alternative policy mixes and assess their social implications. Typically, however, adverse effects cannot be removed entirely; in such circumstances, social safety nets become essential for shielding the vulnerable and generating support for reforms.

[5] Social security programs address normal life cycle contingencies, such as old age, unemployment, and sickness.

[6] Given the IMF's essentially macroeconomic mandate, the IMF's social policy advice has relied on other organizations, particularly the World Bank and the regional development banks, the FAO, ILO, UNDP, and UNICEF, as well as bilateral donors.

[7] More recently, social safety net measures have figured prominently in the IMF-supported programs in Indonesia, Korea, and Thailand (Gupta, McDonald, Schiller, Verhoeven, Bogetić, and Schwartz, 1998). In Indonesia, social safety nets have comprised subsidies for food, fuel, electricity, medicine, and other essential

This paper is organized as follows. Section II discusses the social impact of privatization. Section III focuses on its fiscal implications. Section IV reviews the various methods of privatization and the expected social and fiscal impact of each method. Section V provides an overview of policymakers' options for alleviating any adverse social impact of privatization through social safety nets and other measures. Section VI discusses some experiences under IMF-supported programs. Section VII presents the concluding remarks.

II. Social Impact of Privatization

Assessing the social impact of privatization is not always straightforward. A downsizing of the workforce is only one potential effect of privatization. Also, care has to be taken to separate the impact of privatization from that of other policy changes that occur at the same time, and to consider the entire period over which the restructuring associated with privatization takes place.

A. Labor Adjustments

Privatization can lead to a reduction in an enterprise's workforce. It can also affect salary levels and structure, working conditions, and employees' benefits.

Employment

Policymakers (and workers) often fear that employment will fall when privatization occurs, as the new owners reduce the overstaffing that typically exists to achieve higher productivity. In Sri Lanka, privatization led to 22,738 transport workers being laid off over the period 1981–91; in Bangladesh, the transfer of the jute enterprises to the private sector led to the loss of 33 percent of the managerial and clerical jobs and 7 percent of the manual jobs (UNCTAD, 1995). However, a number of factors need to be taken into account in analyzing the impact of privatization on the labor force.

First, in some instances, the adverse impact on employment may seem small, as layoffs may have been made prior to restructuring. In Chile, significant reductions in telecommunications and electricity companies were made before privatization; consequently, when divestiture took place, layoffs were limited (Kikeri, 1997). In Argentina, close to 30 percent of the workers in five major privatizations had lost their jobs by the time privatization took place (Shaikh, 1996).[8]

At the same time, new ownership and management may lead to an expansion of activities. Hence, the workforce may actually increase over time. In Chile, employment in the telecommunications and electricity companies increased by 10 percent, due to overall

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items; the expansion of employment-generating public works programs; and the strengthening of school lunch and other programs to prevent a fall in school enrollment. In Korea, the emphasis has been on expanding the coverage of the unemployment insurance system. In Thailand, temporary labor-intensive civil works programs have been introduced and government subsidies for urban bus and rail fares maintained to protect urban low-income workers. In 1998, the budgetary costs of these measures ranged from 2 percent of GDP in Korea to 6 percent of GDP in Indonesia.

[8] However, the impact of privatization-related job losses can overstated if the enterprises have "ghost workers."

improvements in the economy and the companies' new investments that accompanied privatization. In a sample of 79 firms in 21 countries, Boubakri and Cosset (1998) find that for the period 1980–92, employment increased by 10 percent or more for 60 percent of the firms. Megginson and others (1994) reach a similar conclusion for a sample of 61 companies in 18 countries for the period 1961–90. In a study of firms in the Czech Republic, Hungary, Poland, and the Slovak Republic, it was found that as the transition progressed, the elasticity of employment with respect to sales increased (Estrin and Svejnar, 1998). This suggests that over the three periods—the preprivatization period, the privatization period, and the postprivatization period—the level of employment in the firm could follow a U-curve: declining during the first two periods and increasing at some point during the third (Figure 1a).[9]

This relationship, however, may not hold for all types of enterprises. Some enterprises may be viable in the long run only with a permanently reduced workforce. Hence, the level of employment over time would follow an L-curve (Figure 1b). Finally, some enterprises may not be viable even under new ownership or with a reduced workforce. For these enterprises, liquidation will be the only recourse, and all the laid-off workers will have to seek jobs elsewhere (see Figure 1c). To deal with the job losses from permanent downsizing or liquidation, privatization should be accompanied by sound macroeconomic and structural policies that promote employment generation (as discussed further in Section V.A.) and provision of social safety nets in the short run. If these policies are successful in redeploying the laid-off workers, the positive impact on employment would be evident at the level of the overall economy, rather than at the firm level.

Second, it matters how the competitive environment and the budget constraint faced by an enterprise change when privatization occurs. If a state enterprise had already been exposed to competition and faced a hard budget constraint, initial overstaffing would be less likely and privatization would add little to the existing incentives for the enterprise to improve efficiency by downsizing the workforce. In Ghana, state enterprises that operated in liberalized markets underwent the same employment reductions as privatized enterprises (London Economics, 1996). If, however, privatization is accompanied by a more competitive environment and/or a hardening of budget constraints, then the adverse impact on employment is likely to be the more severe, at least in the short run. In Benin, Ghana, and Zambia, companies that retained monopolistic power after privatization had few, if any, retrenchments; the highest retrenchment levels were found in industries operating in highly competitive markets (London Economics, 1996). Similarly, Boubakri and Cosset (1998) find that privatized firms newly exposed to competition are more likely to reduce employment.

Salaries, working conditions, and benefits

Privatization can have an adverse impact on salary levels and structure, working conditions, and pay supplements. Again, the time frame is an important factor: initial pay cuts may be

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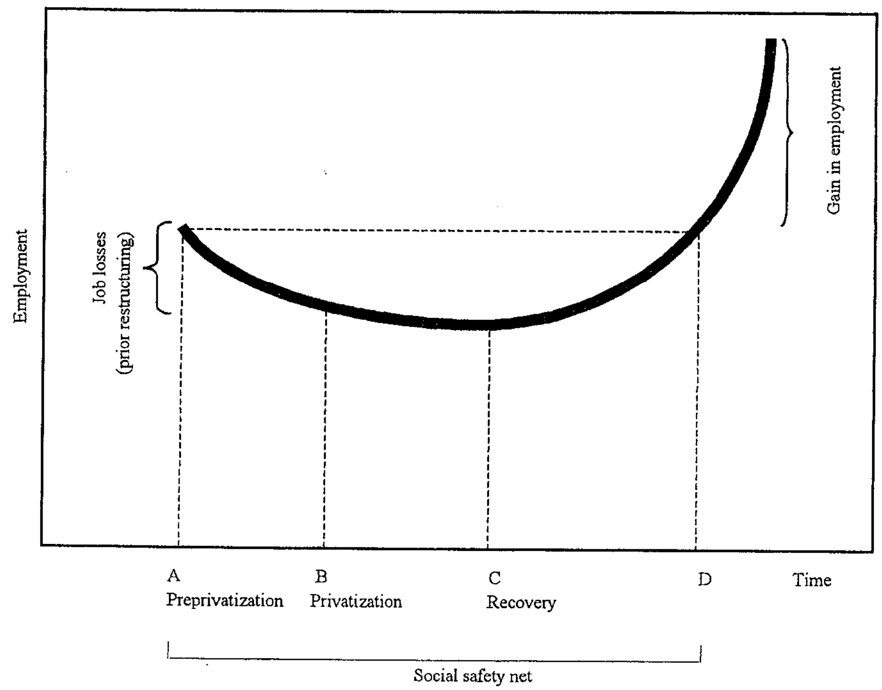
[9] Employment guarantees could complicate this picture. Once the guarantee lapses, the new owner could lay off workers. In Benin and Zambia, the new owners sought to retrench workers even before the agreements had expired (London Economics, 1996).

Figure 1a. Privatization: The U-Curve



followed by future wage increases or perhaps gains from share appreciation (if the privatization involved a degree of employee buyout or preferential allocation of shares). In the case of Malaysia's Kelang Container Terminal, workers benefited from higher wages; in the cases of Teléfonos de México, the United Kingdom's National Freight Corporation, and Chile's electricity company Chilgener, workers benefited substantially from share appreciation (Galal and others, 1994). Pohl and others (1997) find that, in privatized firms in Central and Eastern Europe, wage growth lagged behind productivity growth, with the difference being retained by the firms for productivity-enhancing investments. Nevertheless, real wage growth was significant, due to substantial productivity increases.

Privatization often causes a move toward more performance-based pay schemes, more flexible working conditions (less security of tenure, increased use of nonunionized contract labor, fewer benefits, and longer hours), and larger wage differentials.[10] [11] In Argentina's privatized telecommunications and electricity companies, the workweek increased from 35 hours to 40 hours, wages were more closely linked to productivity, and certain types of overtime and leave were eliminated (Shaikh, 1996). In Mexico's privatized telecommunications, deep-seated changes in labor relations—such as a reduction in the

[10] Other possible effects of privatization on employment conditions include greater job mobility, need for retraining and skill upgrading, increased managerial discretion, marginalization of union influence, and tougher stance of management on worker performance and discipline (UNCTAD, 1995).

[11] In the case of privatizations in Benin, Ghana, and Zambia, although there was indeed a move toward performance-related pay schemes for managers, these managers did not gain higher salaries after privatization. This could have been because the managerial market in Africa is not as tight as commonly assumed (London Economics, 1996).

Figure 1b. Privatization: Permanent Job Losses

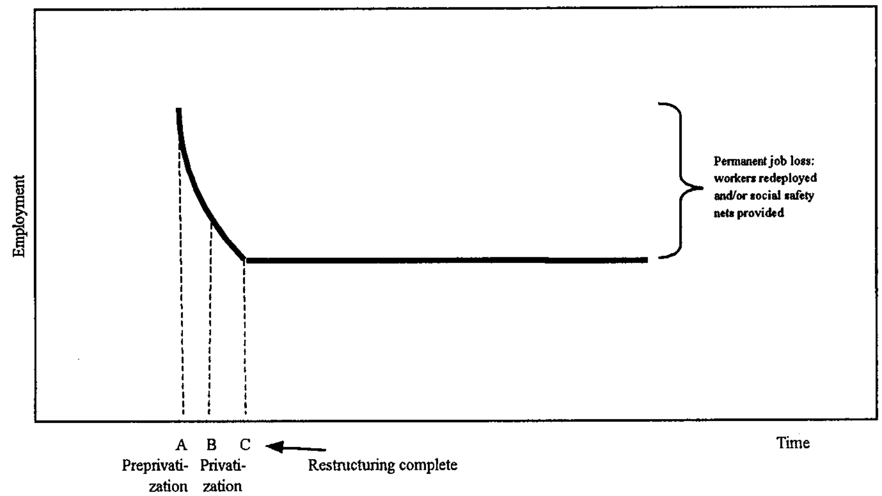
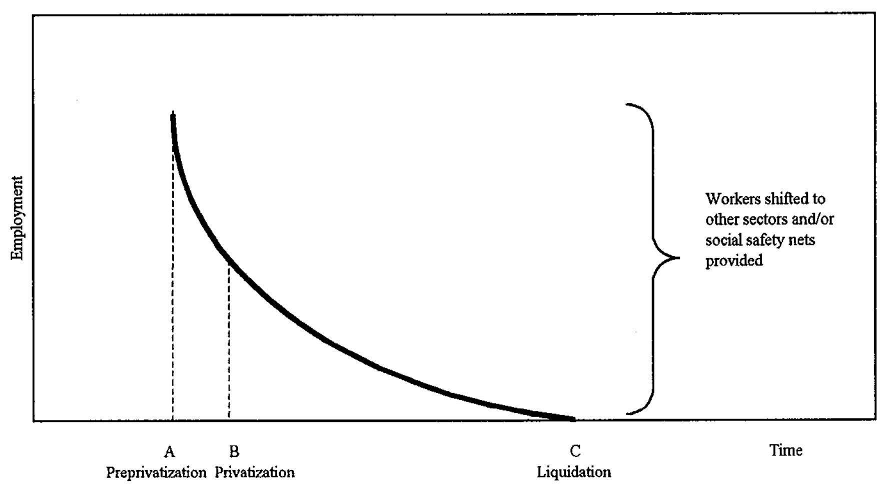


Figure 1c. Privatization: Nonviable Enterprises



number of labor categories and work areas, and an intensification of the work pace—were implemented in return for substantial wage increases (Botelho and Addis, 1993).

In the transition economies, a related problem is the divestiture of the social assets owned by state enterprises. These assets include kindergartens, schools, and hospitals. The divestiture implies that the government assumes the responsibility for the services provided by enterprises. In fact, the transfer of responsibilities should occur regardless of whether the enterprises are privatized or not (Tanzi, 1993). The faster the transfer occurs, the easier it will be for the enterprises to be privatized or to become economically viable while remaining in state hands.[12] In China, the close link between state enterprises and social services has been a major hindrance in the restructuring of the state enterprises. Typically, these enterprises not only provide job security and guaranteed housing at subsidized rents; they also provide day care and schools' leisure facilities, medical benefits, and subsidized consumer goods (Hu, 1998).

In summary, for state-owned enterprises, which are typically overstaffed and pay excessive wages, privatization tends to reduce employment and wages, at least initially. Over time, if a privatized enterprise can expand its activities and increase its efficiency, employment and wages are likely to increase. Two important determinants of how soon an enterprise moves up the U-curve is the extent to which the competitive environment changes when privatization occurs and the presence of employment guarantees. Certain enterprises, however, may be viable only with a reduced workforce, or may not be viable at all even with restructuring. In these cases, policies that facilitate the redeployment of laid-off workers and promote employment generation are important. In the transition economies, a special aspect of privatization is the divestiture of social assets.

B. Price, Quantity, and Quality Adjustments

Privatization can have two contrasting effects on consumer prices. If privatization is accompanied by an improvement in productive and allocative efficiency, then the prices of goods and services produced by the privatized enterprise should decline and their quality should improve. However, if the production of the state enterprises was heavily subsidized, a reduction of subsidies in the context of privatization could lead to higher prices. To the extent that the subsidies kept prices low for the vulnerable segments of the population, these price increases will have an adverse impact on their living standards. However, if the subsidies benefitted the rich or the middle classes (e.g., as in the case of state-owned airlines and telecommunication enterprises), there would be less of an adverse impact on the living standards of the vulnerable.

On the other hand, artificially low prices create an imbalance between supply and demand, with implicit rationing schemes arising to bridge the gap. For example, in some countries, the installation of new telephone lines can entail long waiting periods or bribes to technicians. Often, it is the higher-income households who have the means to surmount these obstacles.

[12] When social assets and their accompanying expenditure responsibilities are unloaded onto local governments without a corresponding increase in revenue capacity, local budgets can experience a major imbalance between revenues and expenditures.

Hence, although the prices charged by state enterprises may seem low, the effective access of middle-class and poor households to these goods and services can in fact be limited. Privatization, by allowing prices to reach equilibrium levels, corrects these supply-demand imbalances, increasing the access of the vulnerable households to previously scarce goods and services.[13] Such effects can often be more important for the vulnerable households.

Furthermore, if a public monopoly is transformed into a private monopoly, that enterprise might exploit consumers, and their welfare would not improve (Vickers and Yarrow, 1991).[14] Therefore, it is important to foster an atmosphere where enterprises pursue profit maximization through increased competitiveness (increasing efficiency and providing goods that consumers actually demand), rather than through exploitation of a monopolistic position to earn rents. This outcome can be achieved through appropriate regulatory and supervisory mechanisms.[15]

The period within which price adjustments take place is also important. The telecommunications sectors in Chile and Mexico provide an interesting contrast. In Chile, price adjustments took place a few years before privatization was effected in 1986–87; hence, privatization was not accompanied by significant changes in prices. In Mexico, prices were kept low prior to privatization, and were adjusted only in preparation for divestiture.

A study of 12 divestitures worldwide (Galal and others, 1994) finds that in 5 of the 12 cases, privatization resulted in losses to consumers. However, in only 3 of these cases (Teléfonos de México, Mexicana de Aviación, and Aeroméxico) were the losses substantial. In 2 of these 3 cases (Teléfonos de México and Aeroméxico), the combined gains of the government, the buyers of the enterprises, and workers outweighed consumers' losses. Consequently, the net change in domestic welfare was positive. In the case of Mexicana de Aviación, the buyers of the enterprises also lost, and their losses, combined with those of consumers, more than exceeded the welfare gains of the government and workers.

C. Changes in Income Distribution

Privatization is often criticized for its purported negative impact on income distribution, on the grounds that buyers may enrich themselves with previously state-owned assets. Privatization affects income distribution through various channels.

The first channel is the shift of real assets from the state to the private sector; this shift has consequences for capital income. If privatization leads to increases in the allocative and

[13] In principle, price liberalization should precede privatization. The fewer the economic distortions in the competitive environment in which the divested enterprises operate, the more likely that productive and allocative efficiency will be achieved.

[14] In the cases of British Airways and Mexicana de Aviación, increased exploitation of market power resulted in price increases (Galal and others, 1994).

[15] The impact of privatization on consumers can vary substantially, depending on the regulatory mechanism. In the case of Jamaica's telecommunications, the foreign buyer was guaranteed the relatively high rate of return of 17 percent on net worth. This implied a substantial negative impact on consumers' welfare. In the United Kingdom, regulators have compelled the privatized utilities to achieve increases in efficiency through the "RPI minus X" framework, whereby the utilities can increase their prices by no more than the retail price inflation less a factor equal to the improvement in productivity projected by the regulator.

productive efficiencies of the enterprises, then the level of capital income would increase; the distribution of the gain between the state and the new owners would depend on the sale prices. If there are no improvements in efficiency, there would be no impact on the level of capital income.[16] In practice, however, changes in the ownership of assets have had important implications for capital income. This is linked to the fact that state-owned enterprises are sometimes underpriced[17] and therefore their sale implies a transfer of wealth from the public to the private sector. In this case, there is a redistribution of capital income from the state (and the taxpayers) to the new owners.[18]

In the transition economies, the so-called nomenklatura privatization and other similar developments are seen as having contributed to the dramatic changes in income distribution. In 1987–88, Gini coefficients tended to be in the mid-20s, which were low by international standards. By the mid-1990s, the Gini coefficients had increased sharply in Ukraine, Russia, and the Kyrgyz Republic—reaching values seen in only a few developing countries—and these coefficients have probably increased further in more recent years (Tanzi, 1999).[19]

The second channel is labor income. The impact on labor income could change over time, as enterprises move from a period of low employment and low pay (during the preprivatization and privatization periods) to a period of increased employment and pay.

The third channel is wage differentials. These differentials are typically greater in the private than in the public sector, and privatization would therefore tend to reinforce them. Again, timing is an issue: The decompression of pay scales can be done rapidly or phased in, depending on the circumstances. Because the average earned income in the private sector is usually higher, due mainly to higher labor productivity, a shift in labor to the private sector can be expected to raise income inequality (Kolodko, 1999).

III. Fiscal Implications

A. Direct Impact

Under state ownership, the government may finance the operations of the public enterprises through subsidies, lending, and capital transfers. On the other hand, the public enterprise may contribute to government revenues through taxes, dividends, and debt service payments. After privatization, these flows between the budget and the public enterprise will virtually

[16] This assumes that the sale price reflects the discounted flow of future earnings.

[17] Tanzi (1999) points out that corruption can play a major role when public officials have discretion regarding decisions on privatization and the conditions attached to that process. It is therefore important to ensure effective governance of the agencies involved in privatization.

[18] Kolodko (1999) concludes that "to measure inequality properly in post-transition economies, one must analyze not how the flow of income is dispersed, but how it is distributed and how the stocks of denationalized assets are divided (p. 167)."

[19] The transition countries for which data are available are the Baltics, Russia, and other countries of the former Soviet Union (excluding Armenia, Azerbaijan, Georgia, Moldova, and Tajikistan); Bulgaria; the Czech Republic; Hungary; Poland; Romania; the Slovak Republic; and Slovenia (see Kolodko, 1999).

cease; instead, the government will receive the sales proceeds and taxes on the enterprise's profits.[20]

The immediate and direct effect of privatization on the budget is felt through the privatization proceeds. If the initial fiscal impact of privatization is positive, it can create room for additional spending on social programs, such as the ones described in Section V. If the fiscal impact is negative, policymakers must adjust the budget by raising taxes or cutting expenditure. The impact depends on a number of factors.[21] In the simplest case, it is zero, because the sale price received by the government for a profitable enterprise will equal the discounted stream of profit remittances that would have been received if the enterprise had remained in the public sector. That is, privatization will only change the structure of government net wealth, but not the level. If the new owner pays a price higher than the existing discounted income stream—perhaps because of the expectation that the income stream will improve after privatization—then the fiscal impact will be positive. Some methods of privatization offer better chances of producing a positive fiscal impact than others. Although mass privatization and restitution do not generate any sales proceeds, they can nevertheless produce a positive fiscal effect if the privatized enterprise had been a net drain on the budget. The risk of underpricing is probably the largest in the cases of negotiated sales to strategic investors and management/worker buyouts, although the risk can be lessened if there are transparent mechanisms for establishing the sale price.

The fiscal impact also depends on how the proceeds are used. Fully spending the proceeds in a given year will augment government spending in that particular year but can create a gap in the following years. Such a gap can be avoided if the government uses the proceeds to retire debt, thereby reducing future debt-service payments. Only to the extent that the sales proceeds exceed the net flows from the enterprises can spending be increased without burdening future budgets.

In their study, Galal and others (1994) find that in 9 of 12 cases, the fiscal impact of privatization was positive. In the case of Malaysia's Kelang Container Terminal, the government earned increased corporate taxes from the enterprise, and benefited from the appreciation of its retained 49 percent share. Similarly, in Argentina, a study of five cases (Shaikh, 1996) finds that the fiscal impact was positive and took the form of sales proceeds, income taxes paid by the enterprises (which had been zero before privatization), higher indirect taxes resulting from higher output, and the elimination of subsidies to the enterprises. In contrast, the Chilean treasury is estimated to have lost dividends and corporate taxes equivalent to 22 percent of the sale price from the privatization of the electricity company Chilgener. For Teléfonos de México, the net fiscal impact was essentially zero—reductions in indirect taxes were compensated by increased corporate tax payments.

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[20] This is a simplifying assumption. There may be other flows between the budget and the private enterprise.

[21] See Mackenzie (1997); and Heller and Schiller (1989).

B. Fiscal Implications of Measures to Address the Social Impact

Privatization may also have indirect fiscal effects. Because governments may choose to establish social safety nets to cushion the adverse impact of privatization, the costs of these programs will also have to be included in the overall assessment. As noted above, public sales and auctions are more likely to maximize the proceeds from divestiture. However, restructuring is also likely to be faster and deeper, perhaps requiring a higher level of spending on social safety nets.[22] For example, policies to redeploy or retrain laid-off workers can entail fiscal outlays over an extended period of time after privatization.

The initial sales proceeds can help finance the attendant social programs. But if sale proceeds prove insufficient, the government will have to either raise additional revenue or scale down other expenditure programs. Ideally, the government should reduce spending on low priority public programs to free resources for social safety nets.

A question can be raised whether privatization proceeds should be earmarked to finance social safety nets (e.g., in the form of severance payments for departing workers). Technically, earmarking is unnecessary because budgetary resources are essentially fungible. In fact, if the proceeds are used to, say, reduce public debt, and therefore future interest payments, the resources thus freed could be used to finance social safety nets. This option may prove more efficient than earmarking the proceeds.[23] Moreover, earmarking can make fiscal management inflexible. By tying up resources, earmarking makes it more difficult for outlays to be reassigned in response to changes in priorities or circumstances.

IV. Methods of Privatization: Social and Fiscal Impact

The method used to privatize enterprises will, to some extent, determine the social impact. In the long run, the method is probably less important, because the levels of price and output are determined by many factors (e.g., technology, consumer preferences, and commodity prices).

A. Sales

Public sales and auctions

Public sales and auctions are most often employed when enterprises are divested singly. Methods include initial public offerings (e.g., British Telecom), sales of shares of already corporatized or publicly traded enterprises (e.g., Philippine National Bank), or public auctions (the prevalent method for privatizing small businesses in Central and Eastern Europe).

To the extent that these transactions are transparent and efficiently conducted, the government maximizes the sale proceeds. But to make the price worthwhile, the new owner must undertake a broad and rapid restructuring; hence, under this method, the impact on

[22] This is discussed at length in Section IV.

[23] According to Aninat and others (1999), prudent overall fiscal management in Chile allowed the repayment of public debt which freed resources for redistributive spending and investment.

workers and consumers can be large.[24] However, as the enterprises also benefit from getting fresh capital—and, in many cases, new ideas—chances are also best for a speedy restructuring and an increase in output, employment, and compensation (i.e., moving up the U-curve in Figure 1a).

Negotiated sales to strategic investors

In contrast to public auctions and sales, negotiated sales enable the government to influence the divestiture to achieve its social objectives or to exclude unwanted buyers (e.g., foreign investors). However, these constraints on the new owner can lead to a lower sale price, reducing the revenues that the government can use to finance social safety nets. Also, once the employment guarantees expire, the government has little leverage for protecting workers. And due to their decreased transparency, negotiated sales give rise to fiscal and distributional concerns; that is, the enterprises can be underpriced during the negotiations, causing a negative effect on the budget through reduced privatization proceeds, as well as benefiting the favored buyers. The risk of an adverse distributional impact in this case is greater than in the case of public sales and auctions.

Management/employee buyouts

Management/employee buyouts (MEBs) have played a major role in a number of Eastern European countries. Under MEBs, there is neither an infusion of fresh capital nor of new ideas. Consequently, employment, average pay, wage differentials, output structure, output prices, and productivity levels change only gradually. In the case of employment, workers will be dismissed only if their wages exceed the value of their average product, rather than their marginal product, as efficiency considerations would dictate (Nuti, 1997). Although this approach appears to offer the greatest chance of minimizing the adverse impact on employment, it also means that the benefits of privatization are delayed.

B. Management or Lease Contracts

Under management or lease contracts, the government retains ownership but delegates the management functions. Thus, there is no transfer of assets to the private sector. Instead, private sector technology and skills are provided for an agreed time and for a fee. Under a management contract, the private company earns a fee for managing the enterprise; the government keeps the profits.[25] Under a lease contract, the private company pays a rent to the

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[24] One way for the government to cushion the adverse impact is to explicitly incorporate in the sale contract conditions to that effect (e.g., in the form of employment guarantees). However, as one study concludes, "As a rule, conditions attached to privatizations by government detract from an enterprise's value because they increase uncertainty or restrain privatized firms' commercial freedom of action (Welch and Frémond, 1998, p. 17)."

[25] In France, before the wave of privatizations in 1986–88, management contracts were an important feature in the state-enterprise sector. In the developing countries, the first concerted effort to implement such contracts was in Senegal in 1980–82; it was not very successful.

government and assumes full commercial risk. Lease contracts are relatively rare in industrialized countries, but common in developing countries.[26]

The impact of these two types of contracts on the budget should be rather similar. If the private company manages the enterprise efficiently, then either contract can produce a steady stream of revenues for the government. The impact, however, can differ in terms of the workforce and consumers. Management contracts typically provide for cost-plus payments to the manager; hence, so long as the manager earns the fee, he/she has little motivation to change the prices charged by the enterprise or to cut the workforce. In the case of a lease contract, the lessor has an incentive to raise prices and cut the workforce, since he/she can keep all extra proceeds net of the lease payment.

C. Mass Privatization

Mass privatization (also labeled voucher or coupon privatization) has been most prominently applied in the transition economies. It does not generate revenues for the government, because the shares are distributed to the population for free or for a nominal fee. A negative fiscal impact can occur, however, if profitable enterprises are divested.

Different technical methods have been applied. In Russia, the shares were distributed directly to the population; in the Czech Republic, Russia, and the Slovak Republic, the population received vouchers for shares of the privatized enterprises, which could be pooled in investment funds; in Poland, the population received vouchers for shares in the investment funds. All of these methods produce, at least initially, a dispersed ownership, providing a potentially widespread distribution of the benefits of privatization. This advantage in terms of income distribution may, however, disappear if the beneficiaries are able to resell their shares too soon: the shareholders can end up selling their stakes for a pittance (as has been observed in Russia), and not benefit from the postprivatization gains in efficiency and output.

Furthermore, if small shareholders lack the capacity to manage their portfolios or to monitor the management of the enterprises, they can lose out to better-informed or better-placed investors. To some degree, Poland's provision that individuals hold shares in investment funds mitigates this danger. The concentration of shareholdings in the funds ensures effective corporate governance, and, to the extent that the funds are well-regulated, the individuals' stakes are protected.

D. Restitution

Privatization through restitution—the return of nationalized properties to their former owners—has been prominently used in Estonia and, to a lesser extent, the Czech Republic (Havrylyshyn and McGettigan, 1999). Outside the transition economies, restitution has

[26] Lease contracts were used in the Lao People's Democratic Republic. In Jamaica, during 1981–92, one-fourth of the 32 privatizations were leasing arrangements, mostly in tourism and agriculture (UNCTAD, 1995).

played an important role; for example, in Uganda, where the Museveni government restored the businesses confiscated in the 1970s.[27]

Under restitution, the adverse effects on workers and consumers are likely to be as large and as rapid as in the case of public sales and auctions. Because this approach is governed by legal and judicial considerations that may be outside policymakers' discretion, the options for preprivatization restructuring and for incorporating social concerns in the transfer of ownership to the private sector are quite limited. Moreover, restitution does not generate any revenues, but in the case of a loss-making enterprise, the budget no longer has to cover the losses.

V. Policy Responses

Thus, privatization appears to impact on employment opportunities, prices, the budget, and income distribution. Governments have a range of policy options to address these concerns.

A. Dealing with Labor Adjustment

Policymakers have four principal options for alleviating the adverse impact of privatization on workers. First, the downsizing can be carried out in a way that minimizes the adverse impact. Second, the government can engage in passive labor market policies (such as severance payments and public works programs), to support the displaced workers during unemployment. Third, the government can pursue active labor market policies (retraining and other programs), to help the unemployed find new jobs. Finally, job creation in the private sector can be encouraged through sound macroeconomic and structural policies.

Cushioning job losses

Restructuring prior to privatization and employment guarantees following privatization have the advantage of spreading out the downsizing over a longer period (see Figures 2a and 2b). In the former East Germany, most privatization contracts contained a special clause guaranteeing employment levels for a specified period, with penalties for noncompliance. In Pakistan and Sri Lanka, employment was assured for one and two years, respectively, after privatization (UNCTAD, 1995). One potential advantage of employment guarantees is that by the time the guarantees expire, a more favorable macroeconomic environment may have emerged. The danger is that, by complicating the process of privatization and limiting the discretion of the new owners, employment guarantees can lead to lower sale prices and decrease the revenues available to finance safety net programs. Furthermore, guarantees can perpetuate the existing inefficient labor practices and delay the desired gains in productivity and efficiency.

[27] In post-1973 Chile, the first wave of privatization consisted of the restitution to their previous owners of assets confiscated under the Allende government.

Figure 2a. Privatization: Employment Guarantees
(Nonviable and Downsized Enterprises)

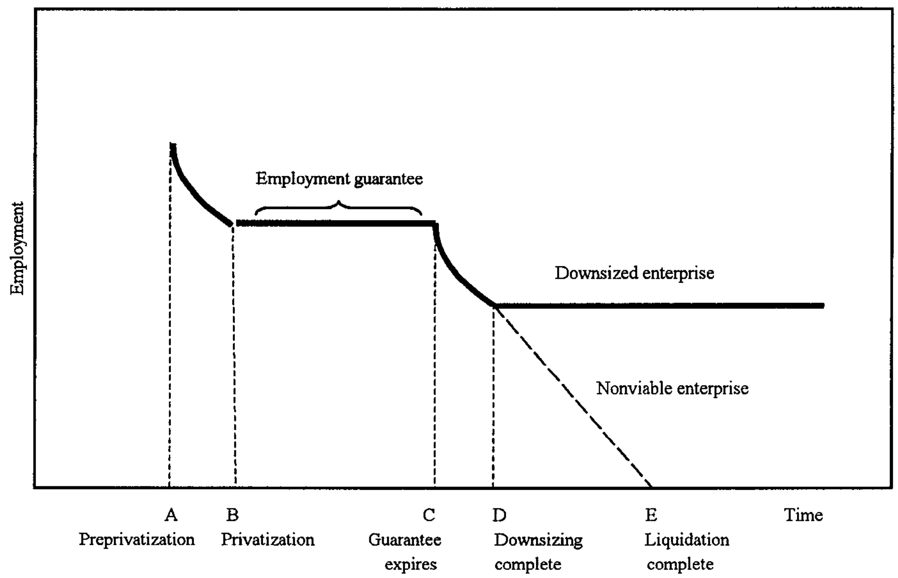
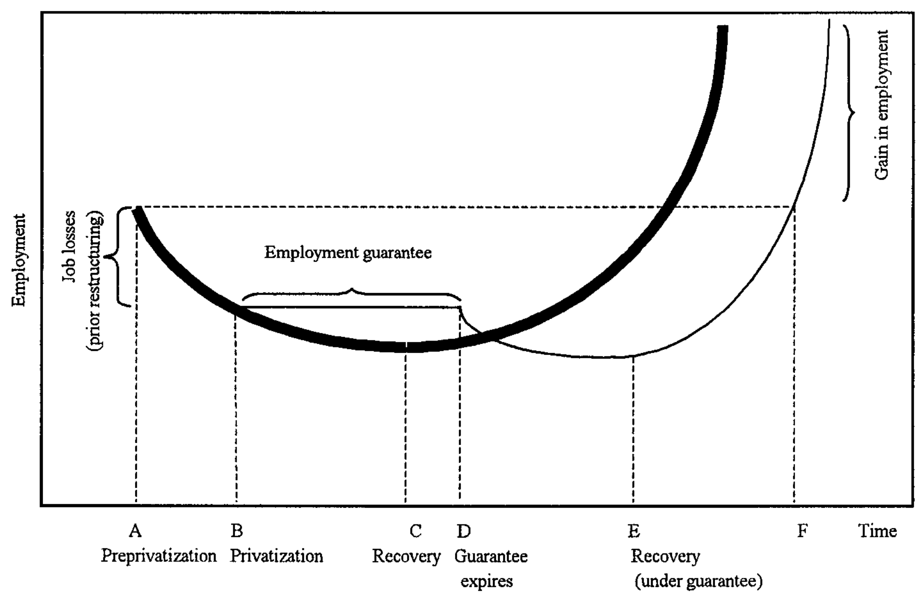


Figure 2b. Privatization: Employment Guarantees



Providing income support

One means of providing income support to displaced workers is to provide cash support, either through severance pay (perhaps as part of early retirement under voluntary-departure programs, which are often more politically and socially acceptable than retrenchment), preferential allocations of shares, or unemployment insurance schemes. If it is sufficiently generous, severance pay can reduce labor opposition to privatization. In Argentina, the government and donors paid for an average of two years' severance payments to workers in the railway, telecommunications, and steel companies (Kikeri, 1997). Whether the enterprise or the new owner pays severance has no material importance, because the cost is reflected in the sale price. Ultimately, the government finances the severance payment, either through the direct provision or a reduced sale price. The fiscal cost for severance payments can be large. In Mali, generous severance payments—two years' pay, plus up to two years' salary to establish new businesses—led the government to halt privatization (Kikeri, 1997).

Argentina, Pakistan, Poland, Sri Lanka, and Venezuela are among the countries that have used preferential allocations of shares to employees to compensate for income losses. In Russia, employees were entitled to 30 percent of the liquidation proceeds. Although this recourse can enhance the political sustainability of reforms, concerns have been expressed that share allocations can lead to excessively fragmented share ownership.

Unemployment benefits can assist displaced workers only if unemployment insurance schemes already exist; in most developing countries, this is not the case. In the transition economies before the initiation of market-oriented reforms, implicit lifetime employment guarantees made such schemes superfluous. With the onset of economic transition, however, unemployment insurance schemes were introduced.[28] In Russia, a small proportion of the total unemployed received unemployment benefits, and in 1993, the average unemployment benefit in relation to the average wage was about 12 percent, substantially lower than the minimum subsistence income for a working person (Gupta and Hagemann, 1998). Similar conditions prevailed in Ukraine in 1995 (Gupta, Harris, and Mourmouras, 1998).

An alternative means of providing income support is through public works programs, which have been successfully used, for example, in Chile, although not in the context of privatization-related job losses. In general, a critical decision in these programs is the level of wages. Wages should be kept low so as not to discourage the unemployed from entering the labor market (Chu and Gupta, 1998).

Active labor market policies

Active labor market policies are aimed at helping the unemployed return to work, to decrease the duration of unemployment. Policies include job counseling and job search assistance (a standard method in OECD countries), assistance and training for self-employment, and

[28] Relevant policy choices to consider in establishing such schemes are coverage (e.g., whether to cover temporary, part-time, and daily workers), minimum contribution period, duration of benefits, and level of benefits.

retraining. When labor demand picks up, these policies ensure that there is a supply of appropriately skilled labor to meet it.

Sound macroeconomic and structural policies

Privatization does not take place in a vacuum; it is usually one element of a larger program of macroeconomic and structural adjustment. The more effective the program is in fostering a dynamic private sector, the easier it will be for displaced workers to find new employment and the less the need for social safety nets. Hence, policymakers need to complement privatization with macroeconomic and structural policies that are conducive to growth and private sector development. Reforms that promote flexibility of labor markets are especially important. Eliminating obstacles to private sector job creation—such as restrictions on hiring and firing, and excessive payroll taxes—facilitates the restructuring process and smooths the movement of workers to private employment.

B. Mitigating the Impact of Price Adjustments

To the extent that vulnerable groups are affected by price increases resulting from privatization, measures that protect their consumption can be considered. In general, though, privatization does not result in large enough price increases to merit special compensation. At the same time, care has to be taken to ensure that affected vulnerable groups do not receive double compensation—in conjunction with that provided for loss of job opportunities.

C. Choice of Method of Privatization

The policy responses discussed above are options that governments can use to mitigate the negative social impact of privatization *after* privatization has been implemented. *Before* implementation, however, the government may have a choice in selecting methods that have potentially fewer negative consequences. This may not be the case in all circumstances. Restitution, for example, often depends on legal considerations and may be outside the government's discretion.

In terms of the *potential* social impact, MEBs are most likely to maintain the status quo, whereas at the other extreme, public sales and auctions are likely to produce the largest adverse impact in the shortest time. MEBs can therefore be attractive to governments that wish to avoid employee layoffs and compensation cuts; however, this also delays the benefits of privatization, thereby undercutting economic reform.

Management or lease contracts are more likely than MEBs to impact on employment and workers' compensation—depending on how much discretion is given to the managers/lessors to operate the enterprises—but not as much as in negotiated sales, as the ownership actually changes only under sales. Negotiated sales provide an opportunity for the government to impose conditions to mitigate the impact of privatization.[29] There is potential for fine-tuning the conditions. The cost, however, can be a lower sale price. Hence, the more arm's length

[29] For example, when Volkswagen gradually assumed ownership of the Skoda Automobile Company in the Czech Republic, it agreed to more than double production over 1990–2000.

the method of privatization, the less able the government will be to dictate its form. It is for this reason that public sales and auctions are the most likely of the methods available to have an adverse social impact. On the other hand, public sales offer the best potential for maximizing privatization revenues and achieving the efficiency and growth benefits of privatization.

VI. EXPERIENCES UNDER IMF-SUPPORTED PROGRAMS

A recent IMF study of progress under the ESAF (IMF, 1997) concludes that the implementation of public enterprise reform has been slow, uneven, and subject to extensive slippages. Furthermore, few countries have divested large enterprises in the strategic sectors. Following is a brief survey of some countries' experiences with privatization under IMF-supported adjustment programs.

As part of IMF-supported programs, *Bolivia* privatized all its public enterprises (the largest of which was the petroleum company). Bolivia employed an innovative variant, called capitalization, which mixed elements of mass privatization and public sales. Under this approach, the new owners put in capital amounting to 100 percent of the preexisting value of the enterprise, thereby gaining 50 percent ownership of the privatized enterprise. The remaining 50 percent is held by pension funds on behalf of the citizenry. An infusion of new capital and new management was thus assured, enhancing the chances that privatization would increase efficiency and output. At the same time, the citizenry could participate in the postprivatization gains, which has positive implications for the distribution of income and wealth. There was very little observed loss of employment in the privatized enterprises, but this could have been because the excess employment had been maintained in the state-retained residual enterprises that continued to perform some of the former functions of the privatized ones.

In *Egypt,* the public sector's share of economic output and employment (about 33 percent) remained broadly unchanged during the mid-1980s to the mid-1990s (Handy and others, 1998).[30] However, since January 1996, there has been a remarkable effort to divest state enterprises: 84 companies have been divested, with a market value representing over one-fourth of all nonfinancial enterprises. Controlling interest was sold in 80 percent of these companies (chiefly through stock market flotations and liquidation), and a minority interest in the others. Privatization proceeds amounted to 1.5 percent of GDP per year during 1996–97, which compares favorably with recent international efforts at privatization.

These 84 enterprises were spread over several sectors (e.g., agriculture, construction, food, engineering, and retail), and about 60 percent were profitable. Despite the norm that voluntary redundancy entails a payment of three years' salary and benefits, restructuring costs were not high, due to the relatively low wage rates. The redundancy payments were financed by a share of the privatization proceeds and by funding from the Social Fund for Development (which is financed by multilateral and bilateral donors). It is interesting to note that in 7 of the 10 enterprises sold to employees, profits improved after privatization by an

[30] This had also been partly due to an increase in the size of the state oil company, arising from oil price increases.

average of 60 percent. The postprivatization evidence points to two reasons for this improvement: first, the enterprises that did better were those that had operated in a competitive environment (e.g., through exporting) even before privatization; second, strategic investors (especially foreign investors) were crucial in increasing efficiency.

In *Estonia,* virtually all small enterprises (about 1,500) were divested by 1994 (mainly via auctions and open tenders, to the highest bidders for cash), and most of the large enterprises were divested by 1997 (Berengaut and others, 1998).[31] The sales of the large enterprises were based on the asking price, business plan, investment, and employment guarantees; hence, their disposal resembled negotiated sales to strategic investors—in fact, these investors were favored over management and employees. This focus on strategic outsiders has resulted in the infusion of modern skills and an enhanced capacity for capital investment, thereby potentially hastening the movement up the U-curve. Rapid restructuring was facilitated by an effective bankruptcy law and the drying up of budget subsidies to the enterprises at the outset of transition.

In *Ghana,* prior to privatization, government subsidies to the 300 state enterprises amounted to 9 percent of total government expenditures. In 1988, in the context of an IMF-supported program, the government implemented a divestiture program, which by December 1995 had succeeded in privatizing 159 enterprises, with almost one-fourth being liquidated (Ariyo and Jerome, 1999).

Ghana's privatization had several problems, however. First, local participation was limited, due to difficulties in mobilizing domestic capital. Second, because several successful bidders lacked the required funds, not all divestitures were completed. Third, the fiscal cost was large (Kikeri, 1997). Severance payments averaged an estimated 52 months of base pay, which was about 65 percent higher than in the private sector. The practice of paying redundant workers retirement benefits (in addition to severance payments) added to the high fiscal costs of labor retrenchment. Moreover, between 1985 and 1991, per person termination costs grew to about 6–7 times Ghana's per capita GDP. On the positive side, Ghana belongs to that small group of countries that have succeeded in divesting large enterprises in the strategic sectors (IMF, 1997).

The Ghanian government set few employment-related conditions on privatization. Furthermore, Ghana, like other governments in Africa, has done little to track the impact of privatization on employment. The only available study of the impact of privatization on labor in Africa (London Economics, 1996) shows that for the sample of seven privatized Ghanaian firms, employment fell by 17 percent following privatization.

In the *Lao People's Democratic Republic,* under an SAF and an ESAF (between 1989 and 1994), 64 of 130 state enterprises were privatized: 78 percent were leased, 19 percent sold outright, and 3 percent bought in installments (Otani and Pham, 1996). In the 28 enterprises for which data are available, employment fell by an average of 14 percent after privatization. However, broader labor force data suggest that the unemployment impact was minor. This

[31] The next phase of privatization in Estonia will involve divesting the remaining large enterprises, mostly in energy, telecommunications, and transportation.

favorable result has been attributed to the private sector absorption of the laid-off workers. Job losses were more pronounced in enterprises that involved domestic investors than in those involving foreign investors. Severance payments (based on the same formula used for civil servants) were the method used to mitigate the social impact. The prevalence of fixed-term leasing was seen as a drawback to new employment generation. Because ownership was unchanged, leasing may not have stimulated investment (e.g., there is no tendency for a movement up the U-curve); in fact, it may have encouraged decapitalization.

In *Poland,* direct sales of the 8,500 state enterprises were not feasible, due to the lack of local capital markets (Ebrill and others, 1994). The authorities chose a multitrack approach. After 1990, state enterprises could opt for so-called "liquidation" (involving both leasing to insiders, comprising managers and workers' councils, and selling their assets), capital privatization (selling shares), or remaining in the public sector. There was no time limit for choosing a method; hence, the enterprises could put off the process. By the end of 1996, 2,700 firms had been liquidated. Nearly 1,300 firms had been leased to insiders and for over 1,400 firms, the assets had been sold. Fewer than 200 firms (typically large enterprises) had opted for capital privatization (usually with a substantial share going to an outside strategic investor). However, capital privatization was the main source of budgetary revenues and was generally associated with strong improvements in enterprise performance, especially when foreign investors were involved. In addition, during 1995–96 another 512 firms were divested through mass privatization: all Polish adults received shares in investment funds that held the shares in the privatized enterprises.

Unemployment rose fast during Poland's transition; not all of the increase can be attributed to privatization, however, as there had also been large changes in the macroeconomic environment. In more recent years, privatization has been occurring in the context of 5–7 percent real GDP growth, and small- and medium-size businesses have provided robust job growth. One striking feature of Poland's experience with privatization is that disability pensions were liberally granted to laid-off workers, thereby providing a form of hidden support. In response, a new law tightening eligibility requirements for disability pensions was passed in 1996.

In *Sri Lanka,* within the framework of IMF-supported programs, 25,000 to 50,000 (depending on the data source) of 120,000 nonplantation workers were retrenched during 1993–94, most before privatization and through voluntary separation with a compensation package (Kelegama, 1997). Because of restrictions on firing, the compensation packages had to be offered to induce voluntary separation. Nonmonetary social assistance (e.g., retraining, redeployment, and advice on how to use the compensation) was not provided. In the plantation sector, which involved a workforce of about 350,000 people, employment guarantees were incorporated in the management contracts, when the government embarked on the privatization of about four-fifths of the plantations in June 1992. While the ownership remained with the government, a lease was offered to the Regional Plantation Companies, which in turn gave management contracts for 5 years to private firms. The restructuring efforts of the private firms were impeded by the government's continued intervention in the new managers' decisions regarding wages and production.

VII. Concluding Remarks

The IMF-supported adjustment programs recognize the social impact of policy reforms and incorporate social safety nets in the program packages. Privatization is one example of a structural reform that can have an adverse social impact, at least in the short run. For workers, privatization can lead to job losses, reductions in compensation, and more stringent work conditions. For consumers, it can lead to higher prices. With regard to the distribution of income and wealth, inequality can worsen, depending on the new ownership of capital assets and the split of the efficiency gains from privatization.

The method of privatization may, to some extent, affect its social impact. MEBs are most likely to minimize the adverse impact, especially on workers. In contrast, public sales and auctions are likely to have a large adverse impact on workers and consumers, due to the new owners' incentive to make the bid pay off, but are likely to maximize the government's revenue gains. Similar effects can be expected from restitution. One way to mitigate the negative effects of public sales and auctions is for the government to incorporate employment guarantees in the sale; however, the faster and broader the restructuring, the sooner the efficiency gains of privatization can be reaped.

The above survey of experiences with privatization makes the following key points:

- The time frame of analysis is relevant. In the short run, to the extent that enterprises have been inefficient, job losses and wage cuts are likely to occur under new management. However, as efficiency gains kick in, employment and compensation can be expected to recover or even exceed preprivatization levels. For enterprises that are not viable even under new management, liquidation is the best recourse; others may have to be permanently downsized. Those laid off under the two latter scenarios will have to be redeployed in other sectors and/or provided social safety nets.

- Private sector job creation is important in facilitating the adjustment. In the Lao People's Democratic Republic, for example, the unemployment impact was minor, as those laid off were absorbed by the private sector. Hence, complementary labor market reforms are needed to make labor markets more flexible and reduce indirect labor costs, thereby facilitating the movement of redundant workers to other jobs. These structural policies should be complemented by macroeconomic policies that foster stability and create an environment conducive to growth.

- Severance payments have been most commonly used to mitigate the adverse impact of privatization, although in some countries they were excessively generous. Employment guarantees have also played a role. Unemployment benefits can help, but they should not be set too high, in order to preserve fiscal stability and encourage the unemployed to reenter the labor market. Early retirement payments and disability benefits can be an easy short-term recourse; however, they are actuarially unsound and endanger the long-term fiscal position.

- The appropriate regulation of the privatized enterprises is critical to prevent transforming public monopolies into private monopolies. Regulation will help ensure that the enterprises improve the prices and quality of the goods and services they provide. Allowing market forces to determine prices can improve the access of the poor to these goods and services.

- The fiscal impact matters. Some methods produce larger revenue gains for the government than others, and these gains can be used to finance social programs during the adjustment period. In cases where the government has the administrative capacity, it may make sense to maximize its revenue gains through public sales and mitigate the resulting social impact through social safety nets. However, public sales can also be expected to have the largest adverse social impact. To some extent, the government has to balance the social costs of different methods of privatization against the benefits of maximizing privatization proceeds. A number of factors enter this cost-benefit analysis: the most prominent are the administrative capacity of the government to run cost-effective social safety net programs, and the social and political circumstances at the time of privatization.

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