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# From Government to Regulatory Governance: Privatization and the Residual Role of the State

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*This article reviews the state of thinking on the governance role of public ownership and control. Optimal governance systems depend on the path of institutional development. Nevertheless, the transfer of operational control over productive assets to the private sector often yields a desirable governance system, because it may be more difficult for citizens to constrain political abuse than for governments to regulate private activity. In weak institutional environments, however, the process needs to be structured to avoid capture of the regulatory process. The speed of transfer should be matched to progress in developing a strong regulatory governance system, to which certain residual rights of intervention must be vested. After all, “institutions” are simply governance mechanisms with some degree of autonomy from both political and private interests. The gradual creation of institutions partially shielded from political power must become central to the development of an optimal mode of regulatory governance. The article presents suggestions for establishing accountability in regulatory governance, in particular by creating an internal control system based on a rotating board with representatives of users, producers, and civil society, in a process involving frequent reporting and disclosure. JEL codes: G38, L33, L51*

The boundaries of state ownership have moved considerably in modern times, following historical events, business cycles, and the ebbs and flows of economic thinking on the role of the state in the economy.

It is difficult to date precisely the early stages of the development of the state-owned enterprise sector. What is clear is that the economic downturn of the 1930s caused by the “Great Depression” led several European countries to introduce an interventionist strategy as public demand for greater social control over markets followed a series of devastating financial crises (hyperinflation, the 1929

stock market crash, banking crises). The French and Belgian governments established financial institutions that took control of the banking sector. In Germany, from the Weimar Republic to the National Socialist period, several state enterprises were created to foster industrialization. Similarly, in Italy in 1933 the state-owned industrial holding company Istituto per la Ricostruzione Industriale (IRI) was established to recover ailing firms and the national economy during the fascist era. Spain imported the IRI model after the Civil War, creating the Instituto Nacional de Industria (INI), with the aim of strengthening domestic development, fostering import substitution, and accelerating growth in underdeveloped areas. In Portugal the “corporative” ideology became the manifesto of Salazar’s authoritarian regime, which aimed to keep political and economic activity under tight public control.

After World War II decolonization created many new independent states eager to engage in nation building and to promote development through state planning and state enterprises. Most of the new African leaders were ideologically attracted to the “commanding heights” of the economy and were convinced that economic planning was the right policy to address poverty and disease (Nellis 2005). As a consequence, several Sub-Saharan countries established socialist (and sometimes Marxist) regimes and based their industrial policies on large-scale nationalization.

Yet the post-war experience gradually led to a drastic rethinking. Evidence confirmed the inefficiency of state-owned enterprises, questioned the motives of politicians in establishing direct control for regulatory purposes, and challenged the social equity of favoring specific constituencies at high public costs.

In the early 1980s the problem of the inefficiency of state enterprises, which were absorbing an increasing amount of public subsidies, became a priority on the political agendas of most European countries, prompting the surge of privatizations that began in the 1980s and gathered momentum from 1991 onwards after the ratification of the Maastricht Treaty on European Union. The restructuring and privatization of the state enterprise sector became necessary not only for modernizing economies, but also for meeting EU convergence criteria without politically costly tax increases. Privatization in developing countries has been spurred since the 1990s, when the International Monetary Fund and the World Bank began to make their assistance and lending conditional on privatization. In the early period the greatest share of privatization activity came from Latin America. After the peak of activity in 1997 revenues from privatizations declined following the East Asian financial crisis and the Russian debt crisis of 1998. The recent resurgence in privatizations in developing countries results from increased activity in China and several Eastern European countries (Kikeri 2005).

After 20 years of privatizations the borders of state ownership have been dramatically redrawn in many countries. The process has unquestionably been successful overall. The general evidence on privatization is favorable in terms of

improvement in firm performance (Megginson and Netter 2001; Kikeri and Nellis 2004). In Latin America privatization resulted in some (small) increases in inequality in the short run, with the gains in efficiency and access to infrastructure more diffused and long term (Nellis 2000). The experiences in Bulgaria, the Czech Republic, Russia, and other formerly centrally planned economies show how voucher scheme privatization programs aimed at broad ownership among the general public can get high-jacked by insiders. Privatization currently under way in China, Vietnam, and other countries is also expected to have adverse income distribution effects.

Thus the experience with privatization has provoked opposition even among early and committed proponents, who find that privatization in some Latin American and Eastern European countries created specific risks and social costs (Nellis 1999).

To explore the relative merits of state and private ownership the article first reviews the literature on ownership, discusses the main drivers of political decision-making, and draws some conclusions on what role state ownership and public governance more generally does or should play in regulating economic activity. The next section introduces some of the basic tradeoffs between private and public ownership of firms. This is followed by a discussion of the intrinsic limits of state ownership in solving commitment problems and a section addressing the risks of privatization in poorly regulated contexts. Finally, the article develops the concept of regulatory governance, advancing some suggestions about institutional development.

## The Costs and Benefits of State Ownership: A Broad Conceptual Framework

State enterprises exhibit significantly lower productive efficiency than comparable privately owned enterprises.<sup>1</sup> The main causes have been traced back to a general absence of accountability,<sup>2</sup> leading to a lack of managerial and employee incentives toward efficiency, problems of competence or corruption by state authorities, and the use of state enterprises for political purposes, to cater to favored constituencies.

Russia provides a conspicuous example of political abuse and capture of state enterprises by special interest groups. Unlike in Central Europe, the power vacuum left after the collapse of the Soviet Union was not compensated for by identification with the West supported by a realistic prospect of joining the European Union. Weak legitimacy made the Yeltsin government vulnerable to the support of special interests and led to the capture of state decisions, which further

undermined support. A distorted corporate and regulatory governance system, in which each strong interest sought to maximize and secure short-term gains, produced a massive build-up of nonpayment of obligations, tax evasion, and asset theft from state enterprises (Black, Kraakman, and Tarassova 2000).

Although state ownership comes with substantial costs, it has been supported by two arguments in the presence of such market failures as market power and externalities (see, for example, Esfahani, Salehi, and Ardakani 2002). One that can be called the “public commitment problem” concerns the difficulty of a sovereign government to credibly commit to refrain from manipulating taxes and regulations in order to collect quasi-rents on relation-specific and often sunk assets. This discourages private investment and may result in direct government involvement in production as a substitute. For instance, state control of infrastructure may be the result of the unwillingness of private investors to fund large investments whose rewards, once sunk, are subject to political decisions.

The public commitment view is buttressed by considerable evidence showing that the size of the public sector is smaller in countries with better institutions, especially those curbing the risk of arbitrary changes in policies, such as contract repudiation and expropriation by the government (Knack and Keefer 1995). La Porta, Lopez-de-Silanes, and Shleifer (2002) find that government ownership of banks is more pervasive in countries with poorly defined property rights, finding support for Gerschenkron’s (1962) view that in these circumstances only the government can promote financial market development.

The second argument, called the “private commitment problem,” identifies the difficulty for regulators in controlling significant decisions by private owners unless government has direct control over the enterprise (see Shleifer and Vishny 1994; Hart, Shleifer, and Vishny 1997). For instance, state ownership of banks may arise because private banks take advantage of depositors or deposit insurance. Most large Russian private banks became empty boxes ahead of the 1998 crises as their capital fled abroad and liabilities piled up. Depositors and foreign investors took large losses. In the end, the experience led most retail depositors to turn to state-owned Sbarbank.

Both these rationales for state ownership presume that state authorities seek to correct classic market failures such as externalities, natural monopolies, high information costs, or public goods. Yet rather than assuming such a public objective, it seems useful to discuss under what governance forms there will be enough public scrutiny to ensure political attention to public welfare.

In general, commitment problems apply to both private individuals and state authorities under incomplete private contracting and its public sector counterpart, incomplete legislation. The critical difference is that the sovereign state has greater discretion and thus greater scope for abuse.

For example, a typical cost of market contracting is the possibility of “lock-in.” When the transaction extends over a long period of time and is potentially affected by unforeseen contingencies, one party may be exposed to the risk of exploitation when some relation-specific investments must be made. Under incomplete contracting these costs are usually mitigated by assigning ownership rights to the parties most severely exposed to these risks. Under incomplete legislation the greater scope from exploitation and abuse comes from the fact that the government can write rules and enforce them, exposing the private party to an additional “regulatory risk” that was absent under private contracting. Indeed, the government can not only renege on a contract, but it can also modify legislation for its own advantage.

Thus the main argument against state control arises from the combination of broader discretionary powers and the potential for political opportunism. Given that many developing countries have weaker institutions constraining public abuse, the case for state control is particularly difficult precisely in contexts where its need may in principle be the greatest.

Obviously the balance of costs and benefits of state ownership depends on the particular path of institutional development and will therefore vary with circumstances. However, constraining public abuse may be more difficult than regulating private economic activity. In that case a more desirable governance mode implies the transfer of ownership rights to the private sector combined with open regulation. While privatization is necessary for productive efficiency, open regulation is needed to achieve allocative efficiency. This proposition implies that private ownership creates better incentives to improve firm productivity but firms must be suitably regulated in order to maximize social surplus.

There is a broad consensus that privatization usually fails to deliver much of its potential in poor institutional contexts, when weak regulation leads to either public or private abuse. Yet regulation can also fail, when it leads to regulatory capture or (in the extreme cases) to state capture. Examples are the large privatization programs in Chile in the late 1970s, in Mexico in the 1980s, and in Russia in the mid-1990s. In some early Latin American privatization programs large private investors were grossly favored in the privatization of the large state banks that were sold cheaply and on highly leveraged terms. This enabled these investors to fund the acquisition of control over a number of privatized firms. In all these cases the abuse of bank resources for private purposes led to brutal financial crises, which forced the renationalization of most of these groups (Velasco 1988). Russia’s experience is also instructive on how captured privatization programs can undermine the authority of the state and other institutions (Perotti 2002). In contrast, China’s gradual privatization, favoring entry while retaining control over the process, has limited private capture of the process, although it still leaves some uncertainty about the possibility of a gradual retreat.

Thus the relevant notion of nonprivate governance appears to be *regulatory governance*. Regulation needs to be explicit in order to expose both public policy and private behavior to greater public scrutiny. To function properly in poor institutional contexts, however, regulatory institutions may need to be accompanied by societal institutions that are able to detect or respond to abuse. A grassroots form of governance may be required to create legitimacy and scope for increasing independence from the executive branch of government. But before the mechanics of regulatory governance and its relation with residual state ownership are described more precisely, the following section explores the limits of state ownership and control in pursuing social welfare.

## Self-Interested or Benevolent Government?

Sappington and Stiglitz (1987) present the classic case for state ownership and control, which occurs when information, contracting, and bargaining costs limit the government's ability to regulate by *ex ante* design. They also suggest that when the government cannot determine its precise objectives due to lack of experience, it may want to retain direct control to avoid costly contract renegotiation procedures with private parties. To the extent that intervention has large costs, state ownership (or rather, state control) is to be preferred to private ownership (Hart, Shleifer, and Vishny 1997).

Yet the regulation of state enterprises by politicians suffers serious drawbacks. First, it is widely known that temporary powers extended to public institutions tend to become permanent. Thus it may be difficult for dispersed citizens to intervene to reverse state control once its purposes have ceased to exist. Second, it is hard to induce politicians to represent the interest of the electorate over special interests and to avoid conflicts of interest.

When voters are poorly informed or too dispersed to coordinate collective responses, politicians are able to pursue special interests at the cost of the common good. If selfish politicians are prone to corruption and patronage (Shleifer and Vishny 1993), the inefficiency of state enterprises is due not only to weak incentives, but also to deliberate political decisions to transfer resources to supporters (Shleifer and Vishny 1994). Such indirect targeting, distorting productive choices, produces inefficiency (Biais and Perotti 2002), such as excessive employment and wages above marginal productivity.<sup>3</sup> For instance, state enterprises may build plants in economically unfavorable but politically attractive regions (Martinelli 1981). Other inefficient political benefits include the production of goods that are not socially desirable.<sup>4</sup> Politicians may even distort the regulatory framework ahead of a state enterprise sale to reduce

future competition, thus maximizing revenues (or bribes) at the cost of consumer surplus.

Even ignoring the most blatant cases of political abuse, the empirical record of state enterprises solving market failures is quite poor. Externalities such as pollution were not visibly better managed by state enterprises than by private firms, as the environmental situation in Eastern Europe vividly illustrates (Grossman and Krueger 1995). Public monopolies often abuse their market power, not necessarily by charging high prices but by tolerating sheer inefficiency, allowing their employees a Hicksian “quiet life,” or by granting preferential treatment to political constituencies (Kikeri, Nellis, and Shirley 1992). This form of internal capture has led to low rates of investment under state monopoly in many countries. Primary examples are the energy and telecommunications sectors, which often expanded and modernized their infrastructures only after privatization and the resulting increase in competition (Bortolotti and others 2002).

If outright state ownership and control do not yield efficient outcomes, the issue becomes how to establish a credible time path for the retreat of direct state control to the emergence of genuine, more accountable forms of regulation.

## Privatization, Regulatory Capture, and Institution Building

Privatization outcomes are heavily affected by the institutional setting in which divestiture takes place. In countries where public regulation cannot control private activity, the speed of privatization should be aligned with the progressive strengthening of institutional foundations. Where the institutional foundations to support or regulate private activities are completely missing, rapid privatization may lead to an unacceptable loss of control over the economic system. Under these circumstances privatization cannot escape capture and may even weaken corporate governance (weak regulatory, bankruptcy, and takeover procedures; corrupt legal enforcement) and lead to a loss of ultimate control over the process and its goals. Major structural reforms can thus fail when their design leads to regulatory capture or (in extreme cases) to state capture.

In a grand political bargain to buy out opposition to privatization most Russian enterprises became controlled by their managers (Shleifer and Treisman 2000). Perhaps there was no other way to securely establish private property in Russia than to “buy in” the potential opposition. Yet it appears that the extent of control transfer to the managers seriously weakened the ability of the state to control the reform process. Many structural reforms, such as bank legislation, the sale of the most valuable resource companies, the public debt market, and the

provision of currency hedges were implemented in a compromise with powerful interests.

A spectacular example of policy capture was the debt for shares deal negotiated on the eve of the 1996 presidential elections. Through a highly dubious secured loan a few influential banks captured control of the best natural resource companies, creating a number of financial–industrial groups. Cash-generating companies in these groups were milked by controlling shareholders, leading to major conflicts with investors and, more recently, with the new Russian government.<sup>5</sup> The high opportunity cost of cash payments (because of the high appropriability of cash for managers) also fed a massive demonetization of transactions and a shift to barter, an extremely inefficient payment system.<sup>6</sup>

In contrast, in China the state has retained control over privatization and deregulation, and private capture of the reform process is more limited. While success with privatization has been attributed to its gradualism, the critical element may have been privatization by favoring entry rather than rapid transfer of control. Arguably, the Chinese economy had ample underutilized resources, and its industrialization had barely begun, so there were many free resources to deploy. In the former Soviet Union reforms required massive reallocation of resources frozen in inefficient production, and considerable uncertainty remains over the possibility of further retreat.

Privatization can lead to increased efficiency and improved welfare only in settings with enough capacity to ensure protection of property rights, contract enforcement, control of market abuse, fair regulation and open entry, and commercial dispute settlement based on law, not payments.

At the same time, there are enough cases of poor performance of privatization in some contexts to acknowledge some objective limits in private control, due primarily to regulatory inefficiency or outright capture. When the transfer of critical assets to private ownership cannot be managed safely (in the sense of avoiding losing control of the sale and the regulatory process), public ownership (and control) can have a temporary role, while institution building takes place. Indeed, under uncertain public commitment, governments can credibly inspire confidence by selling ownership gradually, signaling a commitment to privatization through the willingness to bear residual risk (Perotti 1995). A parallel argument may be made that the state should keep control over decision rights until proper regulation is in place. In both cases the argument is for temporary, gradually decreasing residual cash flow and control rights. There is evidence that a sustained privatization program contributes over time to resolving uncertainty over political commitment to property rights and leads to financial market development (Laeven and Perotti 2001) and to improvements in measures of corruption and the quality of legal enforcement (Boubakri and Cosset 2006).

Yet to be feasible, the structure and role of this residual ownership form needs to be designed with a temporary purpose from the beginning, however long temporary may be. The suggestion is that without an explicit commitment by the state to release control under some conditions, the process of institution building may not even start.

Thus the state has to be progressively removed from direct involvement in the economy, in order to create some scope for allocating residual regulatory and enforcement rights to new institutions. The emphasis should be on creating increasingly professionalized and autonomous regulatory institutions that draw their legitimacy and right to gain further autonomy from a direct, nonstate form of governance that involves consumers and citizens to a greater extent.

Recent evidence (Djankov and others 2003; Acemoglu and Johnson 2005) suggests that the most important institutions are those that restrain the executive and reinforce its accountability by limiting the abuse of power over those that regulate relationships among individuals. The reason may be that power-restraining institutions also correct political incentives to favor strong private interests, for instance through control of market power, thus undermining the establishment of a level playing field and the process of entry by new producers.<sup>7</sup>

State capture by special interests seriously weakens the credibility of enforcement. While corruption accompanied transition in all countries, its extent in the former Soviet Union led many observers to describe it as state capture, where the corrupting agents hold more power than the corrupted officials. There is evidence that while connected firms benefit, on average, they grow less than do firms in economies less subject to capture (Hellmann, Jones, and Kaufmann 2000). In Russia the private capture of the privatization process weakened the ability of the government to control the behavior of the most powerful private owners (Perotti 2002).

Djankov and others (2003) summarize the case for a further retreat of state ownership even in countries with poor institutions. They argue that the more civic capital a country has, the more it is able to achieve cooperation among its members without coercion. Civic capital, fixed in the short run, is determined by culture, factor endowments, and history. The less civic capital a country has, the less it can “buy” order with extra regulation. Thus less developed countries can achieve less with regulation. Deregulation of competitive markets in less developed countries should then count as a high priority. The presence of relatively high barriers to entry in such countries suggests that regulation is often captured and tends to hinder growth. But just as barriers to entry must be reduced, so too must regulatory institutions be improved. This requires a deliberate policy of greater scrutiny and accountability through a more directly elected form of regulatory governance.

## The Mechanics of Regulatory Governance

The reasoning behind this argument is straightforward. Both private agents and the public sector face commitment problems. Since governments are sovereign institutions, they have more difficulty than the private sector in committing to specific decision criteria. Ideally, government should be constrained by private ownership, and the private sector should be constrained by regulation. Thus the critical question shifts to the governance of regulatory institutions.

Regulatory authorities have grown throughout the developed and developing world as a result of privatization, and they exhibit various degrees of autonomy.<sup>8</sup> But whatever their record, the separation of ownership from regulation tends to generate additional open scrutiny and necessarily improves the governance of the regulatory process, at least as long as it is not captured. One of the most neglected benefits of privatization is the increase in public scrutiny arising from the fact that political control is exercised more at arm's length, or in any case through explicit legislation, so that its goals become more open to public opinion. This is comparable to the case of a firm with dispersed ownership obtaining a public listing, a move that improves the quality of information available for judging its management.

In the language of Pistor and Xu (2002) laws and regulations are necessarily incomplete, just as private contracts are. By default, residual rights to regulate belong to the state. Yet the authority to adjust enforcement under unspecified contingencies could be granted to semiautonomous judicial or regulatory authorities. The role of regulatory agencies is more proactive than that of courts, which may not intervene preventively but may respond only after damaged parties bring legal action. Provided that such regulatory institutions operate under a framework in which they can avoid being captured, granting them progressively increasing residual enforcement rights has several advantages over the assertion of direct state control.

Currently, the degree of regulatory autonomy is politically controlled. In perspective, regulatory governance could instead be made contingent on public approval. As long as the mandate is both explicit and focused, and a reputation can be established (as for central banks), such institutions would have less power and appetite for secondary political goals than do politically controlled institutions. Besley and Coate (2003) argue along similar lines that politically appointed regulators tend to pursue unrelated political goals. They report evidence that U.S. states with elected regulators in place of political appointees choose more pro-consumer policies.

Ensuring that regulators work in an independent and accountable fashion toward their stated goals can be reinforced by a novel approach to governance. Their mandate should be temporary and subject to public review: their governance

should include representatives of consumer and other nongovernmental organizations. Governance in some traditional institutions, such as in mutual banks and administrations of public infrastructure, has included a body of elected representatives of users. This concept should be broadened and further experimented with in other contexts as well.

In short, governance of regulators should take a more democratic, directly elected turn. The logic of the argument is not democratization itself. There are agency and common good problems to this solution as well as to others. The logic of this proposal reflects the sensible economic principle that those who benefit most from proper regulation should be entrusted at least in part with its governance (Hansmann 1996; Besley and Coate 2003). Thus the composition of a regulatory board might include representatives from different constituencies and nongovernmental organizations, elected on a rotational basis from broad lists. The governance assignments of individual organizations might be temporary, and extensions and rotation might be subject to public, rather than political, approval. Regulators should be subject to explicit accountability by the establishment of quantifiable or verifiable goals, with progress to be reported on annually. One task of the external appointees would be to report publicly on their views on the regulatory effort and to contribute to necessary adjustments in the statement of regulatory intents and priorities by increasing public scrutiny.

## Conclusions

The issue of public or private governance in circumstances of market failure hinges on the relative ability to commit to fair and efficient allocation. In general the state has greater difficulty in committing, due to its status. State ownership should remain an extreme solution, not advisable except in circumstances when privatization leads to uncertainty over the allocation of ultimate control. This is evident in cases of executive power and public security, as with the army, the police, and prisons.

In countries where private commitment is hindered by poor legal enforcement, a case can be made for some form of state control. Yet because in such cases the environment is also commonly associated with corrupt politicians and unconstrained abuse of power, the public commitment problem is even more serious. The evidence in the recent literature clearly points to institutional development as a precondition for the functioning of both private and public policy. Worse institutions appear to produce worse macroeconomic outcomes, even after policy choices are controlled for.<sup>9</sup> The conclusion is that in such environments there is too little institutional capacity for proper state-controlled regulation, and thus the balance should tilt in favor of more direct state control.

Of course, this is a static view only. The fact that an institutional framework is too weak to support active state regulation suggests that institutional capacity has to be built up, not forsaken. What are institutions if not governance mechanisms with some degree of autonomy from both political and private interests? The gradual creation of institutions that are partially autonomous from political power becomes central to the development of an optimal mode of regulatory governance.

A residual degree of state control, rather than outright ownership, may have a role when proper institutional mechanisms are not (yet) in place. Yet this role must be progressively reduced by the creation of intermediate, focused regulatory institutions that may offer some weakening of the political grip on decision-making. The shift from government ownership to regulatory governance would include the separation of enterprises from ministries and their corporatization, the creation of independent regulators, and resort to temporary mixed ownership. Such policies should allow a greater exposure to market discipline, better incentives in firms, and an increased accountability toward citizens.

## Notes

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1. Good surveys are found in Megginson and Netter (2001), McKenzie and Mookherjee (2003), and Boubakri and Cosset (1999).

2. Accountability to citizens, not investors, is meant here. While state enterprises are incorporated firms, they have no private shareholders. Nor do lenders play a disciplining role, as state enterprise debt is perceived as a public obligation.

3. Even in the United States state entities typically employ 20–30 percent more employees than their private counterparts (Donahue 1989).

4. The development of the Concorde plane is an example (Anastassopoulos 1981).

5. Large financial–industrial groups, common in underdeveloped financial systems, certainly owe their influence to political support, yet may provide governance and an internal capital market to alleviate credit constraints. Empirical research on Russian financial–industrial groups has shown that while group firms were better managed, cash was reallocated from cash-rich group firms on a massive scale and may have been shifted outside the group (Perotti and Gelfer 2001).

6. As evidence that cash-stripping took precedence over productive activity, barter rose with real interest rates and with ruble overvaluation. Ivanova and Wyplosz (1999) find that both higher monetary growth and higher interest rates are correlated with higher barter.

7. Perotti and Volpin (2004) suggest that in a context of poor political accountability, established interests can lobby successfully for regulation and even selective enforcement in their favor,

blocking entry by new firms. Thus, institutions reinforcing political and regulatory accountability are a preliminary step to ensure proper enforcement of relationships among individuals.

8. A common criticism is that regulatory inefficiency is less observable when buried inside a public institution than when it is subject to public scrutiny, as with public regulation of private activity.

9. See Acemoglu and others (2003) on macroeconomic instability in poor institutional environments.

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