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Astor Lenox and Tilden Foundations

While privatization has its critics in established market economies, entirely different forces are at work in countries emerging from decades of central planning and communist rule. Few would disagree with the proposition that ambitious privatization programs were urgently needed in transition countries to end grossly inefficient, state-owned monopolies' dominance of the economy. Riddled with cronyism, bled to provide illicit funding for the party in power, plundered by corrupt managers and pilfered by staff at all levels, many of these companies were as bankrupt as they were unproductive. They survived only through unsustainable state subsidies and indefensible state protection.

Private ownership could be expected to bring a degree of rationality and efficiency to such companies. A firm's financial and operating performance would improve and the government would start collecting taxes instead of providing subsidies. Against this, formerly subsidized firms, once privatized, would be likely to experience a significant decrease in staff levels that could provoke labor union opposition. By contrast, competitive firms would be likely to experience only minimal lay-offs, if any.

Privatization can result in a diminution of corrupt practices by shifting the emphasis of an operation from an amorphous and opaque public sector to the transparent discipline of the private sector's pursuit of profit. Privatization reduces corruption: Managers of companies make decisions that ultimately have to satisfy owners instead of public officials; government assets for whom no one claims accountability cease to exist. Once privatization is completed, independent businesses can conduct their affairs without government interference.

Nevertheless, privatization pitfalls do exist. The co-existence of state companies with a newly formed private sector creates opportunities for corruption in both sectors. One of the foremost mechanisms for corruption is known as the **"entry-exit economy."** Under this scenario, private companies approach state-owned enterprises to obtain lucrative contracts which include a kickback for managers from the state-owned company.

The "entry-exit" economy is also linked to the privatization of firms by employees themselves. This is one of the most common mechanisms for corporate corruption. For example, the Bulgarian Privatization Law (1996-1997) outlined privileges for managers and employees (10 percent down payment and re-scheduling the remaining 90 percent over a ten-year period). This legal option permitted corrupt managers to negotiate deals with semi-criminal groups and/or the ruling party in order to privatize the state-owned companies they manage. They paid only 10 percent of the market price for their shares. This particular scheme of privatization favored managers, but was not fully enforceable.

*In monopolies, especially in public utilities, privatization can eliminate petty corruption, but can lead to more serious abuses. Therefore, privatization of public utilities should be preceded by the introduction of a carefully planned regulatory framework and the establishment of a regulatory agency staffed with trained personnel.*

As we will discuss, policies must go beyond the mere process of privatization and address the integrity of the markets in which the privatized concerns are to function.<sup>1</sup> As commentators such as economist Jeffrey Sachs have pointed out, a change of ownership in itself is insufficient to achieve economic performance gains. It is only when the legal and regulatory institutions supporting private ownership are in place and functioning that the owners can exercise their new rights and improve productivity and profitability.<sup>2</sup> More than this, schemes that do not create arrangements that are conducive to effective corporate governance are unlikely to achieve the desired outcomes.<sup>3</sup>

Experience in Eastern and Central Europe has shown that privatization can create opportunities for politicians to distribute favors to their friends. Major economic assets have been let go at knock-down prices and still remain in the hands of an elite. New owners who have acquired companies through patronage have tended to be very slow in restructuring them, and many such firms have had to be bailed out by the state.

IMF senior official Vito Tanzi has commented that privatization of “non-natural monopolies” is necessary to keep state enterprises from being used as a corrupt source of financing for political parties financing and for the employment for those with party connections. “Unfortunately,” Tanzi writes, “the process of privatising public or state enterprises has itself created situations whereby some individuals (ministers, high political officials) have the discretion to make the basic decisions, while others (managers and other insiders) have information not available to outsiders so that they can use privatisation to benefit themselves ... The abuses appear to have been particularly significant in the transition economies [in which] terms such as asset stripping and nomenklatura privatisation have been used to describe the abuses associated with the transfer of state enterprises to private ownership... [This] leads to the conclusion that the current interest in corruption probably reflects an increase in the scope of the phenomenon over the years and not just a greater awareness of an age-old problem.”<sup>4</sup>

In some countries, mass privatization schemes have been implemented. They were considered to be a corruption-free way to distribute assets fairly. However, in terms of economic criteria, this approach failed because it did not result in raising capital, improving management or in restructuring companies to meet market challenges.

In many parts of the world, too, even when privatization is not actually corrupt, there have been instances when the officials responsible for the privatization policies (and their private sector advisors) have been inadequately informed as to the value of the assets they are selling. In particular, management buy-outs have been exorbitantly profitable when those individuals calculating prices have had inadequate records of even such obvious assets as land ownership.

If the public interest is to be protected, steps must be taken to minimize opportunities for abuse.

## THE CHALLENGE OF CORRUPTION-FREE PRIVATIZATION

Once a government has decided to launch a privatization program, what should be done to minimize the risks for corruption? In essence, of course, the transaction is very similar to a major government procurement, and many of the procedures for public procurement will be applicable. (These are discussed in Chapter 9.)

Sufficient time should be allowed for the process to be handled professionally, but not so much time as to permit corrupt deals to be negotiated. In the past, various problems have occurred partly because of deadlines set by international financial institutions. Public services have been privatized without suitable time for setting up workable frameworks for regulation. One International Monetary Fund report noted: “In [many] countries undertaking programs of public sector reform, the privatization process has always begun before an appropriate legal framework in the form of a divestiture implementation or state enterprise law is passed.”<sup>5</sup>

Premature privatization can lead to the following problems:

- *Governments are often unable to arrange transparent and open bidding processes or promulgate the necessary regulatory laws.*
- *Managers and employees, fearful for their future and confident of their ability to escape punishment, commonly strip the assets of the entities undergoing privatization.*
- *Many interested parties are able to engage in insider dealing and political manipulation of the process for their own profit.*
- *Many state enterprises do not have the time to become economically viable before being sold off, leading to frequent sales of industries at prices below market value, despite heavy government spending on recapitalization.*<sup>6</sup>

Some specific examples of corruption observed in the privatization process include:

- *Blackmail of potential bidders designed to prevent them from participating in an auction or from increasing their bids*
- *Extorting from serious investors a non-participation fee by speculators who promised to refrain from bidding and/or increasing prices*
- *Organizing “Dutch auctions” with serious potential investors intimidated by threats. In “Dutch auctions,” a high price is set by the seller and then gradually reduced until a bidder accepts the figure on offer.*
- *Purchasing businesses in an auction with the intention of defaulting on the obligation to pay the price by a certain date and of using the business to strip it of its assets or for other purposes before the outcome of the auction is declared null and void*
- *Forging documentation allegedly confirming that an auctioned operation was previously leased to one of the bidders with the aim of using the preemptive right to purchase*
- *Gross undervaluation of assets*
- *Participation of ineligible foreign entities through local entities<sup>7</sup>*

### SOME CHOICES IN METHODOLOGIES

The particular manner in which a given privatization is to be carried out will depend on various social, economic and political considerations.

The processes least likely to be seriously affected by corruption are voucher-based privatization and the process known as “liquidation,” when company assets are sold separately and not in a single package.

Marginally more vulnerable is privatization through the means of **IPOs** (Initial Public Offerings, or “share offerings”), but this does have the benefit of provid-

ing a formal process with public pricing for shares.

Tenders (or “trade sales”) are more problematic; they take time, they are less transparent, and considerable discretion can be involved. Susceptibility to corruption can be reduced if it is possible to have the tender process handled independently and out of the hands of politicians. Tenders do, however, offer greater opportunities for improved governance structures for the companies than is the case with IPOs.

A less attractive form of privatization are the management and employee buy-outs which have been featured in many privatization programs. These have almost invariably presented buyers with the chance to buy shares at less than their market value. Worst of all are the so-called “spontaneous privatizations,” which the economists Daniel Kaufmann and Paul Sigelbaum have described as “the very essence of corruption, being the outright theft of public assets by politicians and enterprise directors associated with the nomenklatura.”<sup>8</sup>

There should be diversity, too, in advisors to the government on any privatization program. Using the same advisor for both strategy and for transaction-specific advice can certainly speed up the process, but carries with it a real potential for giving rise to conflicts of interest. It can also bring the advisor into conflict with the government’s policy objectives. The government may wish to restructure an industry and introduce competition, while the advisor presses for the sale of an asset with monopoly rights attached as a means of maximizing revenue and, in turn, yielding higher commissions for the advisors.<sup>9</sup>

### PRIVATIZATION BEST PRACTICES

Although there are multiple ways to carry out privatization, certain principles should apply throughout:

- *Buyer competition. Auctions and public tenders reduce the risk of favored treatment for select buyers.*
- *A public tender announcement that contains clear and complete information on tender conditions.*

- *Once announced, the tender and privatization terms should not be subject to change.*
- *Equal conditions of participation for all interested parties.*
- *Unlimited access to the company undergoing privatization. Potential buyers should be able to visit the company, consult with corporate management and have free access to the company's financial information.*
- *The bidder's price should be the only criterion for selection of a winning bid.*
- *Direct sales should be avoided. These are the most risky form of privatization, especially when one political party effectively controls the government.*
- *A short timeline that minimizes the time available for corrupt deals to be struck.*
- *Clear and objective criteria should be applied to the privatization process that prevent excessive discretionary powers from being assigned to officials.*
- *Publication of all relevant privatization-related information so that the rules are known to all and the public can act as privatization watchdogs.*
- *Scrupulous adherence to codes of conduct and to conflict of interest rules.*
- *Independent administration of the privatization process. This makes it more difficult for existing corrupt relationships with public officials to be exploited.*
- *Public officials dealing with privatization should be better paid than other civil servants and receive performance-related bonuses for each successfully completed privatization.<sup>10</sup>*

### **CAN PUBLIC SECTOR ETHICS SURVIVE PRIVATIZATION?**

Whatever the benefits of privatization, and however effective the regulatory framework, the question of ethics will always remain open. Whereas government actions can be subjected to public inspection through the legislature and an ombudsman, private sector operations are invariably covered by claims of "commercial confidentiality" – a pretext commonly used to deny the public the information to which they would otherwise be entitled.

Performance targets are a useful way of ensuring that privatization yields more than a one-time return to the state budget. These might include the holding of the assets or shares for a stipulated minimum period (to avoid the involvement of speculators), maintaining prescribed minimum levels of employment for a proscribed period of time and perhaps maintaining company research and development divisions.

Lawyers, however, can distort performance targets when they insist that they be objectively verifiable and measurable. Unfortunately, for them it can be not a matter of raising the immeasurable quality of a service, but the provision of measurable quantities. For example, it is not the quality of medical care given by a hospital that interests them, but the number of patients that hospital sees. The formulae lawyers prefer are those which can be tested in court and externally verified, so that it can become a question not of how prisoners are treated in a privatized prison, but how many have succeeded in escaping.

### **CIVIL SOCIETY OBSERVERS OF PRIVATIZATION**

*Civil society organizations can play a constructive role in monitoring privatizations. In 1999, a Bulgarian NGO became involved in monitoring one of the largest and most contentious privatizations in Bulgaria – that of the Bulgarian Telecommunications Company (BTC). As a result of this monitoring, a flawed privatization process was aborted, and a report prepared on measures to be taken to improve the privatization process in the future.<sup>11</sup>*



Half a world away, in Panama, another respected local NGO was invited by the government to sit in as a civil society observer while the sale of the state Panamanian telecommunications company was negotiated. There had been only two bidders, and the government reasoned that the public would be suspicious if the process were not wholly transparent. The NGO was satisfied that the transaction had been properly handled and reported this to the public. As a result, what could have been a highly contentious privatization passed off without controversy.

Given public distrust of politicians and of private sector interests, privatizations will always carry a degree of political risk. Experience suggests that this is best minimized by making the whole process as transparent as possible, including, most importantly, the criteria against which the bidders will be judged.

### **CORRUPTION, PRIVATIZATION AND COMPETITION POLICY**

Corruption does not, of course, take place only within the public sector. Nor is it restricted to public procurement transactions involving both the public and private sectors. It can also take place within and between private sector organizations when corporations abuse market power in areas of the economy that should be governed by a country's competition policy.<sup>12</sup>

The development of a sound competition policy is an essential tool for protecting and promoting economic activity, and for underwriting the integrity of private sector activities. It determines appropriate ways in which the private sector should function, thus ensuring that its performance serves the best interests of all. After the collapse of communism, there was a belief that a government could privatize a conglomerate without first breaking it up, and assume that import competition would prevent the abuse of market power. But this overlooked a variety of factors, such as structural barriers to imports from exchange rate issues, poor transportation systems, and often corrupt regional and local governments that moved to protect their enterprises from competition of any sort.<sup>13</sup>

A prime purpose in developing a sound competition policy is to minimize the scope for rigging markets. To this end, cartels and bidding rings should be outlawed. Such a policy also aims to reduce barriers to business entry, thereby expanding opportunities for small and medium-sized businesses. Another objective is the establishment of sound corporate governance.

Some might be forgiven for thinking that competition policy and its laws are designed only for rich and urban societies. However, today's industrialized countries also once labored under the handicaps of rampant corruption and blatantly self-interested government. To escape from this situation, these countries opted for competition policies governing their market activities.<sup>14</sup>

Although it can be said that every country has a policy on competition, even if this is not articulated and amounts to simply letting the status quo remain undisturbed, those who are consciously developing their policies tend to enact competition laws.<sup>15</sup>

Others might think that competition law is intended to impose forms of capitalism at the expense of the poor and the vulnerable. In fact, its functions are, if anything, the reverse. They are not confined to the economic. They also include social objectives, including equity, the welfare of consumers and the enhancement of the quality of life for all (and particularly that of those most at risk).

### **CONDITIONS FOR A SUCCESSFUL PRIVATIZATION PROCESS**

Conditions for a successful privatization program include:

- *A strong political commitment to privatization coupled with a wide public understanding of and support for the process*
- *The creation of competitive markets through the removal of entry and exit barriers*
- *Financial sector reforms that create commercially-oriented banking systems*

- *Effective regulatory frameworks that reinforce the benefits of private ownership*
- *Clear and detailed procedures for conducting privatization negotiations and selecting buyers<sup>16</sup>*
- *Advisors are hired through open and transparent competition and work only in the interests of the government.*
- *Transparency in the privatization process itself*
- *Transparency in the treatment of privatization proceeds<sup>17</sup>*

- *Measures to mitigate adverse social and environmental effects from privatization.<sup>18</sup>*

Competition law builds and sustains public confidence in institutions, and so, in the end, can help underpin the stability of democracies. It is the key to an effective market economy. Many now believe that the route to development for the world's poorer nations lies by way of enhancing private sector activity rather than by way of the failed government-led commercial activities of the past. A sound competition policy can, therefore, provide the bedrock for a country's development.

## ENDNOTES

- 1 Public Services International (PSI)'s Research Unit, based at the University of Greenwich in London, claims that multinationals privatizing water in the developing world are dogged by corruption, close to financial collapse and have long track records of exploiting the poor: <http://www.labournet.net/world/0208/psi4.html>
- 2 Jeffrey Sachs, Clifford Zinnes and Yair Eilat, The Gains from Privatization in Transition Economies: Is Change of Ownership Enough?, <http://www.imf.org/External/Pubs/FT/staffp/2001/04/zinnes.htm>
- 3 Privatizing State-owned Enterprises: An Overview of Policies and Practices in OECD Countries (OECD, Paris, 2003) ISBN 92-64-10408-9, p.17.
- 4 Vito Tanzi, Corruption Around the World, IMF Staff Papers Vol. 45 No. 4 (December 1998)
- 5 External Evaluation of the ESAF, Report by a Group of Independent Experts, IMF, 1998, p.94. <http://www.imf.org/external/pubs/ft/extev/index.HTM>
- 6 See Sue Hawley, Exporting Corruption: Privatisation, Multinationals and Bribery, The Corner House Briefing 19, 1 June 2000 ([www.thecornerhouse.org.uk/pdf/briefing/19\\_bribe.pdf](http://www.thecornerhouse.org.uk/pdf/briefing/19_bribe.pdf)).
- 7 Ivan Miklos, Privatisation Corruption Risks, <http://www.internet.sk/mesa10/PRIVAT/CORRUPT.HTM#III.1%20small-scale%20Privatisation>
- 8 Daniel Kaufmann and Paul Siegelbaum, Privatisation and corruption in the transition: <http://www.worldbank.org/wbi/governance/pdf/siege12.pdf>
- 9 Privatising State-Owned Enterprises (supra), p. 62. The book contains advice on ways of establishing distinct mandates for advisors.
- 10 These criteria include those drawn from the privatization criteria recommended by the German Advisory Group for Privatisation in Ukraine: [http://www.privatisation.kiev.ua/Priv\\_Eng/rounde/XIX/10yearsE.htm](http://www.privatisation.kiev.ua/Priv_Eng/rounde/XIX/10yearsE.htm). See also the work of the OECD Working Group on Privatisation and Governance of State-owned Assets [http://www.oecd.org/document/36/0,2340,en\\_2649\\_37439\\_2431588\\_1\\_1\\_1\\_37439,00.html](http://www.oecd.org/document/36/0,2340,en_2649_37439_2431588_1_1_1_37439,00.html); German Advisory Project on Privatisation in Ukraine: [http://www.privatisation.kiev.ua/Priv\\_Eng/aboutE.htm](http://www.privatisation.kiev.ua/Priv_Eng/aboutE.htm). Germany has a high level of expertise in the transformation process gained as a result of the reunification process. The legal, economic and social changes in East Germany were without precedence in European history. The German government believes that this experience gives it a clear picture as to the scope of work involved in privatization and the time required to accomplish it.
- 11 The methodology has been published by Transparency International as a toolkit for like-minded organizations: [http://www.transparency.org/toolkits/2001/ccinp\\_telebulgaria.html](http://www.transparency.org/toolkits/2001/ccinp_telebulgaria.html)
- 12 See Chapter 26, TI Source Book 2000 for a detailed discussion: <http://www.transparency.org/sourcebook/26.html>. See also Thailand's Competition Act, 1999: <http://www.oecd.org/dataoecd/40/45/2491524.doc> and South Africa's Competition Act, 1998: [http://www.compcom.co.za/thelaw/thelaw\\_act\\_competition\\_acts.asp?level=1&child=1](http://www.compcom.co.za/thelaw/thelaw_act_competition_acts.asp?level=1&child=1).
- 13 For a detailed discussion, see John Nellis, The World Bank, Privatization and Enterprise Reform in Transition Economies: A Retrospective Analysis: <http://lnweb18.worldbank.org/OED/OEDDocLib.nsf/0/A8579A9A28A100B485256B6D006542F6?opendocument>
- 14 For a discussion, see Jeremy Pope, Competition Policy and Containing Corruption <http://www.transparency.org/sourcebook/26.html>
- 15 At present some 80 of the World Trade Organization's members have such a law, and the number is increasing. Recent examples include Thailand and South Africa, where competition commissions have been established.
- 16 Poland is a country that has been reported by the OECD as having established a set of clear, detailed and transparent processes which have allowed trade sales, or sales to corporations, frequently foreign, which already trade in the same sector. to be used as a successful approach: See Privatising State-owned Enterprises (supra), p. 93
- 17 In Poland, proceeds have been earmarked for social security reform. The Czech and Slovak governments have also earmarked funds for special purposes. In the UK, Sweden and Denmark the proceeds have simply flowed into a general revenue fund. Establishing a special purpose fund is believed to be one way of reducing the likelihood of underselling public assets in the interests of short-term liquidity. Under the German Federal Budget Code, the administration must obtain the full value of the company by ensuring that it realizes the best price the market offers. Privatising State-owned Enterprises, (supra) at p 84.
- 18 See John Nellis and Sunita Kikeri, Privatization in Competitive Sectors: The Record to Date (World Bank): <http://econ.worldbank.org/view.php?topic=20&type=5&id=15960>. See also the OECD Working Group on Privatisation and Governance of State-owned Assets (formerly the OECD Privatisation Network)