المركز المصرى للدراسات الإقتصادية
ECES
The Egyptian Center for Economic Studies

WINNERS AND LOSERS FROM PRIVATIZATION: INTERNATIONAL EXPERIENCE AND SELECTED POLICY IMPLICATIONS FOR EGYPT

LEROY P. JONES

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CONTENTS

FOREWORD

No economic issue has been the subject of political debate more than the issue of privatization. Whereas this debate has subsided somewhat following the collapse of communism, the welfare impact of privatization continues to be clouded by political predilections, flawed measurements and erroneous interpretations. At the most basic level, opponents see privatization as a redistribution of wealth to capitalists at the expense of workers and consumers. Proponents see it as a key ingredient to efficient markets and economic progress. The gains from privatization could further be divided in such a way as to enhance income distribution.

Theory and empirical evidence are equally divided. Theoretically, the welfare impact of privatization depends on whether countries enhance market competition and adopt appropriate regulatory regimes in the case of monopolies. Empirically, the literature comparing the performance of private and public firms is far from conclusive. This ambiguity is what makes the lecture by Prof. Leroy Jones all the more important.

In this DLS publication, Lee presents the results of two very carefully undertaken studies about the welfare effects of privatization on all the actors involved in five countries and diverse sectors. His primary conclusion is that privatization could very well lead to a win-win situation for buyers, sellers, workers and consumers. However, this positive result is contingent on the transparency of the sale process, the extent of competition in the markets, and the appropriateness of the regulatory regime in the case of monopolies. This basic conclusion is particularly important for Egypt, especially as the country moves to the second wave of privatization, which may include utilities such as telecom and power.

Ahmed Galal

Executive Director, ECES

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تقديم

لم تحظ قضية اقتصادية بقدر من الجدل مثل قضية خصخصة منشآت القطاع العام. ورغم أن الجدل حول هذه القضية قد خفت حدته بعد انهيار الشيوعية إلا أن تقييم آثارها مازال مشوباً بالأهواء السياسية للمقيمين فضلاً عن التفسيرات والمعايير الخاطئة. فبينما يرى المعارضون أن عملية الخصخصة هي إعادة لتوزيع الثروات لصالح الرأسماليين على حساب العمال والمستهلكين فإن المؤيدين يعتبرونها ركناً أساسياً من أركان اقتصاد السوق وارتفاع الكفاءة وعليه فإنها ضرورية لتحقيق التنمية الاقتصادية. كما أنه من الممكن تنفيذ الخصخصة وتقسيم مكاسبها بشكل يحقق العدالة للأطراف المختلفة.

وهذا الخلاف له ما يبرره من الناحيتين النظرية والعملية. فمن الناحية النظرية تتوقف نتائج الخصخصة على توافر المنافسة في الأسواق وكذلك على صلاحية القواعد التنظيمية وخاصة في حالة الشركات الاحتكارية. أما من الناحية العملية فإن الكتابات الاقتصادية التي تقارن أداء الشركات العامة والخاصة لا تزال أبعد ما تكون عن الوصول إلى نتائج نهائية وحاسمة وهو الأمر الذي يزيد من أهمية هذه المحاضرة المتميزة للدكتور "لي جونز".

ويطرح "جونز" في هذه المحاضرة نتائج دراستين حول آثار الخصخصة على رفاهية جميع الأطراف المشاركة في هذه العملية في خمس دول وفي قطاعات مختلفة ويخلص إلى نتيجة رئيسية مؤداها أن عملية الخصخصة قد حققت مكاسب عديدة لكل من البائع والمشتري والعمال والمستهلكين. إلا أن التوصل إلى هذه النتائج الإيجابية مرهون بعدة عوامل منها: مدى شفافية عملية البيع وتوافر المنافسة في الأسواق وأخيراً صلاحية الإطار التنظيمي في حالة الشركات الاحتكارية. وتعد هذه النتيجة ذات أهمية بالنسبة لمصر خاصة وأن الموجة الجديدة من الخصخصة قد تشمل مشروعات البنية الأساسية مثل الاتصالات والطاقة.

د. أحمد جلال

المدير التنفيذي المركز المصري للدراسات الاقتصادية

مارس ٢٠٠٢

ABOUT THE SPEAKER

LEROY P. JONES

Professor of Economics at Boston University

Leroy P. Jones has been Professor of Economics at Boston University since 1976. Prior to this he served with the US Peace Corps, worked for USAID and for the Harvard Institute for International Development HIID.

Jones received his Ph.D. from Harvard University and has worked in most areas of applied micro-economics in developing and transitional economies, including: Regulation, Government/Business Relations, Entrepreneurship, Corporate Governance, Industrialization Strategy, and Cost-Benefit Analysis. In particular, he has focused on State Enterprise Reform and Privatization. Dr. Jones has worked in more than 30 countries, including nine years of residence in Asia and has authored and co-authored 7 books and numerous articles.

Part I
Winners and losers from privatization

1. Issues

What makes a privatization program "successful?" There are at least three Levels of answers to this question, and each can be addressed with more or less sophistication:

1. TRANSACTIONS ACCOMPLISHED: How much privatization was there? How many sales? What was their value? Did it result in a significant reduction in the size of the public enterprise sector as a share of GDP?

2. WELFARE IMPACT: Did privatization lead to behavioral changes that enhanced national welfare? Did profits increase? Efficiency? National economic welfare?

3. DISTRIBUTIONAL IMPACT: Did the net benefits of privatization get distributed in a way that society perceives as broadly equitable?

All three levels are important, as they are interdependent. There will be no distributional impact if nothing changed; and nothing will change if nothing is sold. A more subtle form of interdependence involves political economy: if some transactions are completed in a way that is perceived as distributing the benefits unfairly, then future transactions may be in peril. This is all too common a story in Less-Developed Countries (LDCs) with mixed economies. A program is announced with great fanfare, a few transactions are completed in a way that is seen by many to be unfair, contributing to rising political opposition and a hiatus in sales lasting for many years. Turkey's initial efforts were proto-typical. In the early and mid 1980's Turkey was lauded as an early model by many in international development organizations: the government announced a grand plan which had political commitment and a well-designed program, but by the end of the decade, not much had happened.[1] They sold a bridge[2], a plant manufacturing telephone instruments, and several cement companies (later abrogated on appeal) but not much else. Many countries have replicated this experience.

Not everyone would agree with this view. At a World Bank conference, Lord John More, a Minister in the Thatcher government, observed that although he was pleased that privatization had enhanced welfare in the United Kingdom (as had been shown in a paper just presented), this was not a goal of the government. Privatization was a goal in and of itself and they would have gone ahead even had welfare been reduced. While this is an extreme example of a purely ideological value system, it is possible to take a similar view on more pragmatic grounds. That is, it is possible to argue that the only important test of privatization is getting the deed done, because we know that this will eventually enhance true welfare, regardless of what any short- or medium-term studies might show.

The view taken here, in contrast, is that while divestiture cannot reduce welfare in a perfectly competitive economy —and in fact is most likely to enhance it— divestitures typically take place in a non-competitive environment. Historically, for example, in South Korea, three-quarters of public enterprise output was sold in markets which were monopolies, oligopolies or monopsonies and the bulk of the remaining quarter was in highly concentrated manufacturing industries with 4 firm, 4 digit concentration ratios averaging 0.73.[3] In such an environment, it is at least possible that privatization will reduce welfare, with any efficiency gains offset by the use of monopoly power to exploit the consumer. The potential for diminished welfare is not confined to natural monopolies, as the following vignettes suggest:

> In one Asian nation, a privatized food processing plant doubled output and quadrupled profits. The new owner attributed this to a string of efficiency-oriented managerial reforms. Opposition politicians attributed it to the fact that as part of a side-deal, competing imports were banned for five years.

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[1] Other than providing employment for consultants, which is clearly a good thing.
[2] An important bridge to be sure: the one connecting Asia and Europe across the Bosporus.
[3] See (Jones and Mason 1982).

> In another Asian nation, the first divestiture was of a large manufacturing firm protected by high tariffs. It was sold on a closed private placement basis to a close relative of the President.
>
> Elsewhere in Asia, a transportation monopoly was sold cheaply to an organization controlled by the ruling political party.
>
> An African steel mill was leased to a private buyer, which resulted in great improvements in profitability. However, the plant produced very little itself, making its money on imports of which it was the sole licensed supplier.
>
> In Latin America, a privatized telephone company raised prices by several hundred percent.
>
> Also in Latin America, a large privatized company is said to have used its influence to obtain subsidized government credit, thus crowding out more competitive private borrowers.
>
> A large manufacturing plant was sold to a large number of small shareholders. Because of agency problems in an under-developed capital market, this is alleged to have resulted in management pursuing its own interests by using previously unexploited market power and taking the gains as pay raises and perks for themselves.
>
> A large transportation firm was declared bankrupt by the government. Its assets were sold to a private buyer the same day. The firm reopened under private management the next day and hired back only half of the old workforce.

This list could be extended indefinitely, but hopefully it suffices to make three points. First, it is possible for privatization to reduce welfare globally, or at least for some important stake-holders. Second, this potential is not confined to monopoly output markets, but also can occur when there are imperfections in input markets (capital and labor) or, most importantly, in the market for discretionarily granted government privileges (tariffs, quotas, licensing of competitors, access to under-priced credit, etc.). Third, such allegations, even if unproven or untrue, lend powerful support to opponents of privatization. In general, the fear is that privatization will benefit buyers of the firm at the expense of consumers, workers and those who gain from high input prices (suppliers) or other forms of inefficiency (bureaucrats controlling the enterprise).

It therefore would seem of more than just passing interest to inquire into the second and third measures of success mentioned above, namely the resulting welfare change and its distribution. There is not a lot of evidence on this, and it is not easy to do the work, but one set of studies suggest how to go about answering such questions and offer some tentative hypotheses as to the answers.[4] The next two sections are derived from this source, and the paper will then conclude with some observations on Egypt.

2. *Welfare Impact Study: Sample and Methodology*

Case studies were originally conducted on twelve enterprises in Chile, Malaysia, Mexico and the United Kingdom. One drawback of this work was that it included only middle income countries (above $2000 GDP per capita) so results of a more recent study on the Ivory Coast (five case studies) will be included here.[5] These enterprises are listed in Figure 1. Note two important points:

1. The sample of enterprises is reasonably typical of the public enterprise sector in mixed economies, consisting predominantly of large, capital intensive enterprises operating in monopoly or oligopoly markets, plus the Ivorian plantations common in Africa.

2. The sample of countries, on the other hand, is atypical of the mixed economies, in two ways. First, the UK was the MDC leader in privatization and Mexico and Chile were the greatest early LDC success stories and the Ivory Coast was one of, if not the most, successful privatizer in Africa; only Malaysia had a privatization program whose scope was in the vicinity of the mixed economy norm. Second, all four countries had quite competent economic management during the period of study, undertaking a host of reasonably effective market-

[4] See (Galal, et al. 1994). The following two sections draw on this volume without further attribution.
[5] See (Jones, Jammal and Gogkur, 1999).

oriented reforms in addition to privatization. One therefore has to be careful not to confuse the consequences of privatization with the consequences of other economic reforms.

The biased country sample was the result of two pragmatic considerations. First, the methodology required a time series of post-privatization behavior (ideally, 5 years) and it was primarily the forerunners who met this requirement. Second, the methodology requires considerable data on the performance of the firm, both pre- and post-privatization, and this required strong government support of the study. Only governments and enterprises confident in the consequences of their actions are likely to offer intimate access to their enterprises. Because of this success bias, results of the studies can therefore only be used to suggest what **can** happen rather than to predict what **will** happen elsewhere.

Figure 1. The Sample

Country	Company/ Sector
Ivory Coast	Rubber Rubber Palm Oil Electricity Telecom
Chile	CHILGENER (Electricity distribution) ENERSIS (Electricity distribution) Telecom
Malaysia	Malaysian Airline System Kelang Container Terminal Sports Toto Malaysia (lottery)
UK	British Telecom British Airways National Freight
Mexico	Telefonos de Mexico Aeromexico Mexicana de Aviacion

Source: Galal, et al. (1994) and Jones, Jammal and Gogkur, (1999)

The methodology applied to this sample comes in two parts. First, how is welfare change to be measured and allocated? Second, how do we know how much of any change is attributable to divestiture rather than other contemporaneous events? Each methodology is outlined below to give the reader a flavor of what was done.

Our measure of welfare change is the standard one used in the Harbergerian Benefit-Cost analysis, that is, the changes in the areas under the supply and demand curves. This begins as the standard sum of changes in consumer surplus and profit. However, some of the gain in profit or consumer surplus may come at the expense of workers (through reduced wages or dismissals), other input providers (contractors, bureaucrats) or competitors. Accordingly, the changes in rents accruing to these groups are added.

Distribution of the welfare changes to functional groups in society is a one-to-one mapping for consumers, workers (and other input suppliers) and competitors, but profit changes must be apportioned between the government seller and the private buyer. Private buyers receive any excess of their maximum willingness to pay (the true value of the privatized enterprise) over the price they actually pay. The government seller receives the balance in the form of the sale price, increased taxes, and increased dividends on any shares retained.

One additional complication is that market prices may not reflect the true value of the transaction to society. For example, in Mexico a dollar earned from foreign buyers was worth more than the peso equivalent at the official exchange rate. We therefore add shadow multipliers (economic price over market price) for each of the variables. Variables are then estimated by completely describing each product market in each period of time. The differences in these figures attributable to privatization are then aggregated across products (typically 10 or so per firm), allocated to functional groups and the resulting streams discounted to Net Present Values.

The second methodological problem is how to decide what share of any observed change is attributable to privatization. Mechanically, this is accomplished by defining a counter-factual scenario, hypothesizing the performance of the firm had it not been privatized. It is only the difference between the factual and the counter-factual that is attributed to privatization, as shown in Figure 2.

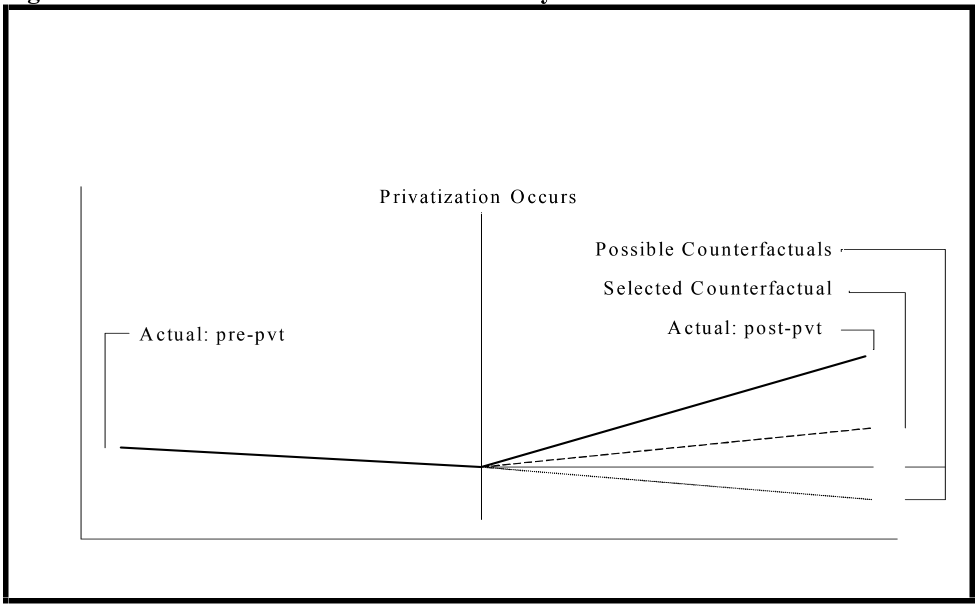
How then is the counter-factual constructed? There are two steps. First, there is an adjustment for macroeconomic conditions. For example, countries typically privatize at the depths of some macroeconomic crisis. Some of the subsequent gains in performance are not therefore due to privatization, but would have taken place anyway. These changes are manifested primarily on the demand side, so the counter-factual uses the actual observed demand[6] except where privatization is believed to have released an investment/capacity constraint or there were clearly identifiable steps by the firm that increased demand (intensive marketing or product improvement or diversification).

The second step in constructing the counter-factual is to include the impact of any other government reforms that impacted on enterprise performance, but that would have taken place independently of whether or not the enterprise was sold. A prime example is prices. A number of countries pursued price liberalization along with privatization and it was generally assumed that these reforms were independent. That is, they would have taken place independently of privatization and so their impact is included in the counter-factual and therefore not included in the gains or losses from privatization.

The reader will note from even this sketch of the methodological issues that there is considerable art of judgment buried in the science of the formulae. The original document therefore contains considerable sensitivity in its analysis, showing the impact of various assumptions. The base estimates reported below, however, reflect generally quite conservative estimates of the positive effects of privatization. It is considerably easier to make privatization look better than it is to make it look worse.

[6]Or the projected privatized demand in later years.

Figure 2. Factual Versus Counter-factual Analysis



3. Welfare Impact Study: Results

Results are summarized in Figure 3 which gives the broadest measure of welfare change, namely that accruing to all stakeholders, whether domestic or foreign.[7] Note first that 16 of the 17 case figures are positive, meaning all but one of the divestitures enhanced welfare overall. This is a strong result for supporters of divestiture, but before we break things down to look at the gains and losses of individual groups, let us consider the outliers at the aggregate level.

The first outlier is Mexicana, where welfare was reduced. Was this a failure of privatization? What happened was that the private buyer made a host of bad business decisions, ranging from expanding capacity in a declining market to using heavy lead-based paint to make the planes colorful but greatly increasing fuel costs. It would be naive to expect privatization to prevent such mistakes. Private businessmen make mistakes just like public managers: a large fraction of private business go bust every year. What is different about the private sector is that there are

[7] To allow meaningful comparisons across companies and countries, the net present values are first converted to an annual perpetuity equivalent, and then expressed as a percentage of sales in the year prior to privatization. For example, the first figure in the table (.02) says that annual welfare gains were equal to two percent of sales in the year prior to privatization.

corrective mechanisms to turn things around. Private firms do not typically lose large amounts of money for extended periods of time: management change, take-overs and bankruptcies are the corrective mechanisms. Public enterprises, on the other hand, have no such corrective mechanisms and often run deficits for extended periods of time. In the case of Mexicana, the welfare losses all occurred in the first three years; thereafter things turned around and privatization was welfare enhancing.

The other outlier was Chile Telecom which showed a positive change of 155 percent. On the surface, this seems too good to be true. What happened? Like Mexicana, this was an investment story, but with the opposite sign: when Mexicana expanded it was the wrong thing to do; when Chile Telecom expanded, it was the right thing to do. Although this company was reasonably well run and regulated prior to divestiture, it had been under a severe investment constraint, resulting in considerable excess demand. With privatization, this constraint was removed, capacity was added, real output doubled in about four years, and consumer surplus rose dramatically (accounting for 131 percent of the gains).

There is an important lesson here. Going into the study, the authors expected the primary source of gains to be in operational efficiency, not thinking of the investment problem. This was foolish because we know that many public enterprises requesting funds for expansion in tough times are told: "we know that it is economically rational, but if we give you money we would have to do the same for the army, teachers etc." Release[8] of such an investment constraint was also a major factor in the gains at British Telecom, Malaysian Airline Systems and the Ivorian plantations.

Another interesting feature of the results is the inverse correlation between benefits and the level of development. That is, roughly speaking, the richer the country, the lower the benefits from privatizing. The reason is straight-forward. Potential gains are greater, the worse the enterprise is managed before privatization. In the UK, British Airways was not a bad airline even before privatization, so the room for gains was modest. The case was similar for the

[8]Strictly speaking, a delay in the release of the investment constraint. In the counter-factuals, we generally assumed that investment was permitted in the public enterprise when fiscal affairs improved, usually after 3-4 years.

Chilean electricity companies. If, in general, public enterprises are more poorly managed in poorer countries, then it is natural that the potential gains from privatization (done right) are greater there.

Figure 3. Welfare Changes Due to Divestiture
(Annual Component of Annuity/Perpetuity of NPV over Sales)

Country	Company	%
Chile	CHILGENER (Electricity distribution)	0.02
	ENERSIS (Electricity distribution)	0.05
	Telecom	1.55
	Simple average	*0.54*
Malaysia	Malaysian Airline System	0.22
	Kelang Container Terminal	0.53
	Sports Toto Malaysia (lottery)	0.11
	Simple average	*0.29*
Mexico	Telefonos de Mexico	0.50
	Aeromexico	0.49
	Mexicana de Aviacion	-0.07
	Simple average	*0.30*
Ivory Coast	Rubber	0.52
	Rubber	0.92
	Palm Oil	0.70
	Electricity	0.08
	Telecom	0.17
	Other Agro-Industries	0.51
	Other Infrastructure	0.17
	Other Tradables	0.17
	Other Non-Tradables	0.22
	Privatized Sector Average	*0.25*
U.K	British Telecom	0.12
	British Airways	0.02
	National Freight	0.04
	Simple average	*0.06*

Source: Galal, et al. (1994)

Many other stories are hidden in Figure 3, but need not concern us here, because the idea that privatization is likely to improve efficiency is not too controversial. As noted earlier, the real question is the distribution of the net benefits. Figure 4 therefore breaks down the distribution of the net benefits among government, buyers, consumers, workers, other domestic stakeholders (competitors and rent recipients), and foreigners.

First, let us consider the possibility that welfare gains were at the expense of exploitation of consumers. As shown in Column 4, there were only five cases of consumer welfare loss as a result of divestiture, and the three largest examples were in Mexico. Two quite different explanations for the negative impact are possible. First, it may have been due to private exploitation of monopoly power. Second, it may have been due to privatization leading in the direction of "getting prices right." To distinguish between these hypotheses, one can assume that the privatized firm was identical to the counter-factual in all ways except price changes and looking at the impact of that change alone. Results of a series of such experiments show that the price changes in Mexico were all either roughly neutral or welfare enhancing. This can only be the case if one is moving from an inefficiently low price to something approaching an efficiency price. Illustratively, then, Mexico's Telecom prices were among the world's lowest in the pre-divestiture period; privatization accelerated an inevitable trend towards an efficient level, and hurt consumers by removing an un-economic subsidy. Four of the five cases of consumer losses were thus due to efficiency-pricing.

Even so, isn't the move toward rational pricing a cost because it worsens income distribution? Not necessarily. It depends on who is being subsidized. It's not the poor who were flying on the airlines or consuming telephone or electricity services in Mexico, but the upper and middle classes. Raising the prices of services such as these generates revenue that can be used to expand these services or provide better public education or health benefits. And according to the extent to which this is done, income distribution is not harmed, but enhanced by efficiency pricing.

There was one case of consumers being harmed by exploitative pricing. This was in the UK where the study argues that the British Airways merger with British Caledonian would not have happened under continued public ownership, and that the result was a non-competitive increase in domestic fares. Because the domestic market is only a small share of British Airways' total, the effect is small in magnitude, but important in principle.

Figure 4. Winners and Losers from Divesture (ACPE %)*

Country/Company	Government	Buyers	Consumers	Workers	Others	Sub-tot	Foreign	Total
Chile								
CHILGENER (Electricity distribution.)	-1.4	2	0	0.1	0	0.7	1.4	2.1
ENERSIS (Electricity distribution)	-1.6	7.6	2.2	3.9	-7.4	4.6	0.6	5.2
Telecom	8	1	131	1	4	145	10	155
Malaysia								
Malaysian Airline System	5.2	2	-2.9	0.4	0	4.6	17.4	22.1
Kelang Container Terminal	37.6	11.5	6.2	7	-11.9	50.4	3	53.4
Sports Toto Malaysia (lottery)	13.6	10.7	0	0	-13	10.9	0	10.9
Mexico								
Telefonos de Mexico	13.3	11.4	-62	15.6	28.3	6.6	43	49.5
Aeromexico	62.3	3.9	-14.6	2.4	-2.3	52.9	-4.6	48.5
Mexicana de Aviacion	3.5	-1.4	-7.7	0	3.2	-2.4	-4.6	-7
Ivory Coast								
Rubber	15.2	6	0	2	2.4	25.7	26.1	51.7
Rubber	32.5	57.8	0	0.2	1.1	91.6	0.8	92.4
Palm Oil	37	35.1	0	2	-8.2	66	3.6	69.5
Electricity	0.3	1.6	1.6	1.3	-0.4	4.4	3.5	7.9
Telecom	5	0	5	1.1	-0.4	10.6	6.5	17.1
UK								
British Telecom		3.1	4.9	0.2	-0.1	10.8	1.2	12
British Airways		1.4	-0.9	0.3	0	1.7	-0.1	1.6
National Freight		0.8	0	3.7	0	4.3	0	4.3

* Annual Component of the Perpetuity Equivalent (ACPE)
Source: Galal, et al. (1994) and Jones, Jammal and Gogkur, (1999)

Now consider the remaining non-negative consumer impacts. In six cases, the impact on consumers was zero, most commonly because the enterprises were operating in competitive markets (or ones regulated independently of privatization). For example, the world price of rubber or palm oil is not materially altered by actions in the Ivory Coast, so consumers are unaffected. Finally, in five cases consumers were benefited by privatization, largely in infrastructure sectors where the negative impact of increased prices were more than offset by the positive impact of capacity expansion and reduced rationing.

What about the other group that is most often expected to lose from divestiture, namely workers? One of the most surprising results of the study is Column 5 of Figure 4, which shows no case of workers as a class losing. It should be noted that some individual workers who were laid off suffered a loss even after accounting for separation benefits and prospects for new jobs. It is nonetheless significant that in all cases the gains for other workers compensated or more than compensated for this loss. There were two transmission mechanisms for the employee's gains. The first was higher wages derived from unions' strengthened bargaining position as profits rose (especially at Kelang and Telmex). Elsewhere, a major source of workers gains was from appreciating share values.

What explains this counter-intuitive result? Is it a myth that: first, public enterprises are overstaffed and tend to overpay their workers; so that, second, efficiency requires reducing workers' welfare? Yes and no. The case studies suggest that it is not a myth that the public enterprise wage bill is bloated, but that some of the gains from privatization can be used to buy workers' support. In fact, at least in mixed economies, which are not extremely hard, authoritarian states, such an arrangement is a pre-condition to level one success; without it the enterprise will not be sold. Often, workers are guaranteed some combination of freedom from layoffs for a specified period, concessional share ownership, and/or guaranteed maintenance of relative wages. In return, unions relax the onerous work rules which preclude efficiency gains. The result, with better management and incentives, can be rapid reduction in unit costs and expansion of output. Even if enterprises are overstaffed by, say 30 percent, natural attrition and rising output can eliminate the excess employment in a few years. This does not constitute a direct move to the production possibilities frontier, but may be a compromise that is necessary for movement towards that frontier. In any event, this is the primary[9] explanation for what happened in the case studies.

Let us next consider what happened to the buyers and the sellers. As already noted, they play a positive sum game in which any increased profit is divided between them based on the sale price, the percentage of shares sold and the tax regime. The size of the gains to be split is given by the change in public profits (quasi-rents or total operating return to capital). As shown by the sum of Columns 2, 3 and (approximately),[10] 8 in Figure 4, the profit changes were positive in all cases. These were of substantial magnitude in Malaysia and Mexico (with the exception of Mexicana) with a simple average of over 40 percent. In the UK and Chile, on the other hand, the profit gains while still positive averaged below 7 percent. Does this mean that divestiture was less successful in the latter two cases? Any answer must recognize that the UK and Chile firms were reasonably well run under public ownership so that the potential for welfare gains were correspondingly less. The potential gains from privatization are the largest in the most poorly run enterprises. This has obvious implications for the selection of priority candidates for privatization. In the present context it raises the question of whether divestiture success should be measured by the percentage gains, or the percentage movement towards some optimum. By the former standard, Mexico and Malaysia were clearly more successful. By the latter, a case can be made that Chile and the UK were as successful, if not more so.

How were these gains divided? It is widely believed that initial public offerings in general, and initial public offerings of public enterprises in particular, are usually under-priced so that

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[9] A quantitatively secondary factor is that while public enterprises tend to overpay at the lower skill levels, they tend to underpay at the higher levels. Some of the gains therefore are reflected in higher pay for senior managers and scarce resources such as cost accountants. However, the number of such individuals being small means that this is a comparatively minor share of the total gains for employees as a class.
A quite different, and highly country-specific mechanism was working in the Ivory Coast plantations, where lay-offs were concentrated among foreigners, and so appear not under the domestic workers column, but under the aggregate foreigners column.

[10] "Approximately," because the figure reported here to conserve space is the aggregate of all foreign actors. While foreign buyers are the principal component, they are not the only one. For example, the figure also includes benefits to costs to foreign workers in the Ivory Coast and to foreign consumer/passengers on the airlines.

initial buyers receive considerable gains. The sample gives some support to this notion: again with the exception of Mexicana, buyers gained in all cases. However, the magnitude of those gains (with the exception of Telmex) are both small and show low variance (in the range of 1 to 14 percent).[11] This is consistent with the hypothesis that capital markets work, albeit imperfectly, in providing fairly modest premium for risk which is similar across market economies.

Since profit changes show high variance and buyers gains show low variance, it follows that the sellers gains show quite high dispersion, ranging from -2 percent to 62 percent. Governments have gotten especially high returns in Malaysia and Mexico. Part of the reason is that the gains from divestiture were greater than in Chile and the United Kingdom, so there were more profits to distribute. In Mexico, the government ceded considerable control, but few of the benefits, early on. The government kept some shares in trust or as sequestered, nonvoting shares, allowing the private sector to make management decisions and the government to retain the benefits by selling those shares downstream, when their value had increased. Similarly, the Ivory Coast kept substantial interests in several of the divested enterprises, and so profited from the subsequent appreciation in value. Malaysia relied on a variety of profit-sharing mechanisms, especially taxes and special levies. Both governments did a good job of negotiating a large share of profits for themselves. The important question in terms of income distribution is what governments do with these profits. If the funds are used to help the poor by investing in education and health services, divestiture will have a positive effect on income distribution and the poor.

In two Chilean cases, government returns were negative. Does that indicate that divestiture was a mistake? It is possible that the Chilean government could have bargained harder, but the potential gains to be had there were small. Moreover, would an intelligent government be willing to spend $100 million to get $200 million for society as a whole? Governments do this all the time. They invest in roads, education, health services, putting out the money for others'

[11] Note that these gains are those in excess of the opportunity cost of capital.

gain. The same thing happened here. Society as a whole benefited, and the government paid a price. There is an important implication here, which is that the government's reservation price will always be negative if the divestiture is otherwise welfare enhancing.[12] As in any transaction they should try to bargain for more than their reservation price, but this observation provides justification for the low selling prices, which are often received for the first share offering of public enterprises.

Before leaving the government share, it is worth emphasizing that a somewhat surprising result of the study was that the primary source of the gains to government was not primarily from the purchase price. Instead it came from subsequent tax increments, profits on delayed sales of some shares, and the elimination of the need to provide continued subsidies. For example, in the Ivory Coast, only about a quarter of the benefits were from the initial sale, while half came from increased tax collections (and reduced subsidies) and another quarter from sale of later tranches.

What kind of behavioral changes caused the improvements in welfare? The role of pricing and investment policy has already been considered. The gains also came in large part from increased productivity, and much of the productivity gain came from absorbing excess labor by expanding output. The most dramatic case was Aeromexico, but there more broadly defined management reforms were also responsible for the major productivity gains. The Kelang Container Terminal divestiture presents the strongest case for the efficacy of management reforms. Product quality or diversification improved substantially in several cases as well. The Malaysian lottery, Sports Toto, shows what large changes can flow from improving and expanding services. It suggests that enterprises that deal with the public and in which marketing and personal service are important are especially likely to show large gains from privatization.

Finally we need to take account of the impact on other groups. These include both the competitors who lost in the Kelang Terminal and Malaysian Lottery sales and the existing

[12] See (Jones, Tandon and Vogelsang, 1990).

shareholders in Telmex and Mexicana, who, though not included among the new buyers, gained as the shares rose in value after divestiture.

Thus far, we have seen what can be broadly described as Level Three successes. There is, however another important cut which distinguishes not by functional group (workers, consumers, etc.) but by nationality. How were the results distributed between domestic and foreign stake-holders? As shown on the right-hand-side of Figure 4, the bulk of the gains generally went to domestic groups. For example, at Kelang Container Terminal, an Australian firm took over management of the firm and they received a 3 percent ACPE[13] benefit as a result. This however, seems a small price to pay, because domestic benefits totaled over 50 percent. At the other extreme, however, at Telmex, foreigners received a 43 percent ACPE gain while domestic parties got only 7 percent. This is the sort of thing that leads to charges of "selling the national patrimony" and can become a threat to sustainability. I would call this a Level Three failure, but this should not obscure the fact of eleven Level Three successes. Foreigners also did quite well at one of the Ivorian rubber plantations, but this was due primarily to them having held substantial shares pre-divestiture, so they naturally benefited along with the government in the subsequent gain in value.

In sum, these patterns of results show that in these cases, divestiture has clearly been a successful policy if not a perfect one. These results cannot be used to <u>predict</u> similar successes with other privatizations. They can, however be used to <u>prescribe</u> a package of policy measures which lead to Level Two and Three success and thus create a political environment which allows a sustainable privatization program. The view taken here is that the key to sustainability lies in a popular perception of Level Three success. To achieve this requires, among other things: a transparent sale policy so buyers are not thought to have gotten a special deal; an effective post-privatization regulatory regime, to ensure that consumers are not harmed through exploitation; a pragmatic pre-privatization deal with workers to ensure that they are unlikely to lose from the

[13] ACPE stands for Annual Component of the Perpetuity Equivalent

deal; and a sales transaction that ensures the government receives a significant share of the gains, whether through the sales price, deferred capital gains, or increased taxes.

4. Success in Egypt

What are the implications of international experience for Egypt? Since I am not an expert on your country, I will confine myself to asking questions, which perhaps the audience will answer. The first question is simply: "How successful has Egypt been in privatization to date?" A Level One answer is that as of March 31, 2001, Egypt had completed 180 privatization transactions worth LE 13 billion. This is certainly a praiseworthy magnitude, especially given the slow start to the program in the early 1990's and the major institutional obstacles. Still, to provide a comparative perspective, one would like to know how much of the public enterprise sector has been privatized. A hint at the answer can be derived from one report which says that the first 91 enterprises privatized accounted for 14 percent of the market value of the sector.[14] If the size of the subsequent sales were on average of the same size as the initial sales, then by now, about 28 percent of the sector would have been sold. This is clearly a substantial achievement by international standards. Since the sector was larger than average among mixed-economies, one would like to go further and ask how much of GDP has been privatized. Since the sector is far more capital intensive than the sector as a whole, then to scale up from the 28 percent figure we would need to know the relative capital/value-added ratios and the share of the sector in value added. If for the latter figure we take 25 percent and for the former say that the sold enterprises are neither more nor less capital intensive than those retained, then about 7 percent of GDP has been sold.

The foregoing answers to Level One questions are rough, but the orders-of-magnitude are probably about right. However, when we turn to Levels Two and Three, there seems to be relatively little known. Please correct me if I am wrong. If not, given the importance of such

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[14] See (Khattab, 1999)

questions as argued above, would it not be a useful guide to policy to know what the welfare changes are and how the benefits and costs have been distributed?

To make this query concrete, let's try a little projection exercise. Using very round numbers, assume that the welfare gains in Egypt were like that in other good LDC programs, with annual gains of 25 percent of pre-divestiture sales, and that 25 percent of this went to foreigners. Assume further that sectoral value-added/GDP = 25 percent, that sectoral sales=2.25 times value-added (highly intermediate-intensive) and that Egyptian GDP is LE 100 billion. Then, domestic gains from privatizing the whole sector would be .25*.75*.57*100 = LE 11 billion per year. Further, if the distribution of these gains were as in other good LDC programs, the winners and losers would be:

Figure 5. Illustrative Distribution of Privatization Gains-Losses in Egypt

	% of Gains-Losses	**Value (LE billion)**
Government	0.33	3.6
Buyers	0.26	2.8
Consumers	0.10	1.1
Workers	0.06	0.6
Other	-0.01	-0.1
Domestic Sub-Total	0.75	8.0
Foreign	0.25	2.7
Total	1.00	10.7

Source: Authors' calculation.

These are of course only wildly illustrative results, but wouldn't it be useful to have actual numbers for Egypt?

Regardless of the degree of success to date, what of the future? I am told that privatization is slowing down, in part because the easy stuff has been sold and more difficult sectors such as utilities remain. What does international experience have to say about these issues? Answering this question requires an understanding of the basic economics of asset sale.

5. The Simple Economics of Asset Sale and Policy Implications

a. Principles

Consider the following couplet as an explanation as to why it is so hard to sell public enterprises:

> If the company is making money, the government doesn't want to sell; if it is losing money, the private sector doesn't want to buy.

Does this make sense to you? It does at first blush to many informed observers. However, upon reflection, it becomes clear that it represents economic nonsense. If it were analytically sound, how many transactions would there be on the stock market every day? What then constitutes a sound basis for asset transfer?

What if, as a private individual, I want to sell my company to you? The economics of the potential sale may be summarized in our respective reservation prices: the maximum you are willing to pay and the minimum I am willing to take. If my reservation price is higher than yours, then no sale is possible; if yours is higher, then it is. What are these reservation prices? In both cases they are the expected net present values of the future earnings (quasi-rents or return to equity). I won't take less than I could earn by keeping the company, and you won't pay more than you could earn by taking the company.

What are the prospects for sale if you plan to run the company the same as I did, and we both have the same expectations for the future? Under these conditions, the NPVs would be the same, the reservation prices would be the same, and any sale would as a first approximation be a wash transaction, with neither of us coming out richer, but each of us simply rearranging our portfolios. We are playing a zero-sum game, so why play?

Now, what if I am an aged, tired fuddy-duddy and you are a bright young MBA who will run the company far better than I ever could? Now, your reservation price is far higher than mine, and the difference constitutes a positive sum gain, so a sale is possible. Who will get this gain? It will be split between us depending on the degree of competition in the market and our respective bargaining skills. For example, if there are a large number of bidders, I will extract your maximum willingness to pay, and I will get the whole gain. If, on the other hand, you are the only bidder and a skilled negotiator, then you might pay only my reservation price, and you will get the entire gain. Regardless of how the game comes out, it is worth playing, because it is positive sum.

The error in our introductory couplet is now clear. Sales potential does not depend on profit or loss, but on expected **changes** in profit or loss. I may benefit from selling a profitable company if you can run it better, and you may benefit from buying a losing company if I would run it worse. Now let us consider some public enterprise implications of this principle.

b. Implication #1: Sequencing

Which enterprises should be sold first? There are a large number of considerations in this decision, but the basic principles help us understand some of them. What if my goal was simply to make the country economically better off, subject to limited administrative capacity in implementation? Then, I would first sell those enterprises where the welfare gains are the largest. Which are these? Simply, those where the positive-sum gains are the largest. Which are these? Simply, the worst run.

For example, as shown earlier, there were relatively small gains from the privatization of British Airways because it was relatively well run before privatization and consequently there was relatively little to be accomplished by privatization. Conversely, consider a poorly run electricity company characterized by regular black-outs and brown-outs. Now, huge welfare gains are possible for consumers and businesses from better management and resource allocation. In sum, the potential for economic gains is inversely proportional to how well the company is run before privatization.

It follows that what appears to be a problem in Egypt, may be an opportunity in disguise. The remaining enterprises may well be precisely those where the gains are the largest. But how are we to make a deal so as to realize those gains? Part of the answer is a carefully thought-out pricing policy.[15]

[15] Another small piece of the answer is to sell what the private sector will buy. Several Eastern European countries have been successful with a strategy of telling the private sector that they are willing to sell anything (with perhaps a

c. Implication #2: Government's reservation price

When I sell a used car or a government sells an enterprise, we both go into the negotiation with a reservation price (the minimum we will accept) in our pocket. What is the government's reservation price? The answer is surprising at first blush. It can be proven mathematically that under quite general conditions, the government's reservation price is **negative**. That is, it should be willing to pay the private buyer to take over the firm. One's first reaction on seeing this result is that there must be a sign error in the algebra. However, upon reflection, it is perfectly understandable. If privatization is worthwhile, then it makes the country better off. Just as when building a bridge, the government should be willing to **pay** for this improvement.

As a private seller, my reservation price is of course not what I will try to get you to pay. I might be willing to pay you to haul my old junk car out of my front yard, but if I can get you to pay $200, so much the better. Is the government any different in trying to maximize the sale price? Yes and no. Yes, the government is different in not necessarily selecting the highest bidder (for example, the acquirer of a monopoly position would pay more than the recipient of a competitive position). However, once the best (welfare maximizing) bidder is accepted, the government will generally do better as it extracts as much as possible from that bidder. There is a critical caveat here, however, which is that the effort to get a higher sales price will seldom justify economically a material delay in privatization and almost never justify not selling.

The point that apparently needs to be emphasized today in Egypt is that a low price does not constitute "selling the family jewels." If sale is competitive so that is the best price available, then it is, to the contrary, the way to get the most social utility out of the family jewels. In making this point to the politicians and the public, it should perhaps be further emphasized that the initial sale price is often only a minority fraction of the benefits to the government, which in turn is a fraction of the benefits to the public as a whole. This can be illustrated by considering the benefits of partial privatization.

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short exemption list), and inviting serious expressions of interest. With such expressions, then the enterprise is marked up for an auction or other competitive sale.

d. Implication #3: Partial privatization

Around the world, it is common for countries to embark on privatization by considering sale of only a part of the shares. Two obvious variants must be considered, depending on whether or not a controlling interest is sold. When only a minority of shares are sold, and this is insufficient to transfer control to the private sector, then international observers often refer to this as mere "cosmetic" privatization. This judgment rests on two premises: first, that behavior will not change as a result and second, that if behavior does not change, there will be no gains. The second premise simply reflects the "basic economics" explained above, but what about the first? The standard view is that so long as the government is in charge, it will continue to behave as it did before and there will be no change at the enterprise level. The competing view is that even, say, a 30 percent private voice in corporate governance may be enough to tilt at least some decisions in a favorable direction. The argument here is that "government" is often not a monolith, but a collection of "plural principles" each representing a different view. If say, the Minister of Finance cares about profits and efficiency but the tutelary ministry cares about patronage and the legislature about jobs, then the addition of private votes to the influence of the MOF may sometimes tip the balance in favor of efficiency. Or, an efficiency-oriented CEO may be strengthened in his ability to say something like: "I'd love to hire your brother-in-law, but I'd have to explain it to the Board" and there would be an unfavorable □and possibly public□ reaction because of the private-sector representatives. Empirical international experience gives numerous examples of such a positive response to the introduction of private shareholders.

However, such a response is by no means necessary and there are also abundant examples of public enterprises which operate for decades with little or no evident impact from minority private shareholding. The conclusion is obvious. If the alternative is no privatization, then sale of even a minority share-holding may well be a positive interim step. On the other hand, it remains a pale substitute for transferring control.

What about the second variant, namely selling a controlling interest while retaining a significant public share? The argument against such a step precisely parallels the previous argument. That is, so long as there is a public role in the internal decision making process, there is likely to be a diminution of the benefits from privatization. One argument on the other side is again the political feasibility argument that something is better than nothing. There is, however, a more fundamental economic argument in favor of retaining public shares for a limited period of time. This rests on the common observation that —internet offerings of the late 1990's aside— initial public offerings are typically under-priced in the private sector, because of the uncertainty associated with such sales. The uncertainty being much greater with privatization, it is to be expected that share prices will typically —though of course not uniformly— be much higher several years after initial privatization. Accordingly, international experience confirms that governments which initially sell a partial but controlling share, typically receive far more per share on sales of subsequent tranches. Accordingly, government revenue maximization is often achieved by a strategy of retaining a minority share-holding for say 3 years. When selling companies which are large relative to the capital market this argument is reinforced by considerations of absorptive capacity.

The objection to this strategy is two-fold. First, there remains the danger of continued government interference so there is a likely efficiency cost to the distributional benefits. Second, even the distributional benefits are reduced, because the private sector is likely to be willing to pay less per share when there is continued government interference. Some countries have developed a clever tactic for getting the benefits without the costs. They do this by converting the residual government shares to preferred but non-voting shares (or by putting the government's shares in a trust voted by the private buyer). Thus, they transfer 100 percent of control and get the full efficiency gains, but with a larger share of the pie going eventually to government. This tactic might usefully be considered in Egypt.

e. Implication #4: Restructuring

What about another way of getting a higher price, namely restructuring prior to sale? Return to our opening private sector example (I'm an old fuddy-duddy and you are a bright young MBA). Instead of selling you the company and sharing the resulting gains, why don't I hire your classmate, realize the gains before sale, and keep all of the gains for myself? There are reasonable answers to this question in the private sector, involving principle/agent conflicts, incentives, economies of scale and scope and opportunity costs. However, let us assume these away and ask about the public sector.

Why shouldn't Egypt reform/restructure the enterprises before sale and thus reserve the entire gain for the public? The most important answer is empirical. Egypt has at least 40 years of experience with reforming its public enterprise sector, many of the attempts being both systematic and sensible. How successful have these efforts been? Why should the next attempt be any different?

Egyptian experience is not unique, but prototypical. Yes, internationally there are a few examples of well-run public enterprises, but for every one of these, one can name several hundred which are disasters. Yes, there have been reform efforts which produced positive results, but these have proven unsustainable, with practices returning to pre-reform status with depressing speed and regularity. As someone who has been personally involved in some of these efforts, I take no great pleasure in reporting this, but facts are facts.

A pro-reformer might respond to this observation as follows. Fine, we are not naive; we know all that. However, to accomplish our purposes in the current context, the reforms need not be sustainable; if we can turn an enterprise around even temporarily, then we can sell it at a higher price. Even if we can't achieve full private-sector efficiencies, if we can get half of the way there, then we are better off.

This is a reasonable and appealing position and deserves a careful response. Let us assume that this can be accomplished, at least for long enough to bring the enterprises to sale. The question is: what would be gained thereby?

Perhaps the surprising answer is: not much. To see this, revisit the simple economics of asset sale:

> 1. As a first approximation (abstracting from various differences in public and private valuations such as externalities) the potential welfare gain is simply the difference between the reservation prices of the buyer and the seller.
>
> 2. How will the maximum willingness to pay of an informed buyer change if the enterprise is restructured prior to sale? Again as a first approximation (abstracting from differences in timing), the answer

is: not at all. I'm willing to pay the net present value of the earnings (quasi-rents) of the firm as I expect to run it. If you make some of the changes before sale, it won't change this at all.

There are two exceptions, one unimportant and one important.

3. One exception is if the buyer is poorly informed, and the public sector restructuring involves changes he wouldn't have thought of. Since the typical private buyer has run similar enterprises and since public reform is not likely to involve innovations unknown to the private sector, this is unlikely. Reducing the work force, getting receivables down, etc. will presumably occur to most buyers.

4. The second exception involves changes which can only be made, or can more cheaply be made, by the seller. This is a short list, encompassing such things as: cleaning up the balance sheet; legal and regulatory reform; breaking-up the firm into constituent parts; and, sometimes, reducing labor redundancy.

Assuming the latter step is taken in any event, and the former is unlikely, then the conclusion holds that the buyer's reservation price will be unchanged by restructuring.

5. What will change is the seller's reservation price, by the discounted value of the improvements, for as long as they are sustainable. The gains from privatization will thus be reduced, but the sum of the gains to restructuring and privatization will be unchanged. Any gains from the former will be exactly offset by the latter.

If this is so, as micro-economics tells us it is, then why waste time and money in an endeavor which is at best a wash?

7. One possible answer is distributional, as suggested at the outset of this section. Might not the public share of the gains be increased by the process? Unfortunately, this is unlikely. If the sale process is designed to extract as much as possible of the informed buyer's maximum willingness to pay, as it should be, and that maximum doesn't change, then the amount extracted is unlikely to change.

In sum, in an economics calculation, the best that can be expected from most restructuring prior to sale is a wash. Since the best is unlikely to eventuate, it is unlikely to be a prudent step.

There may be good and sufficient political arguments for a government to delay privatization. If so, then reform/restructuring is a useful step and may well have interim economic gains. If, however, the true goal is to privatize, then restructuring has little to recommend it economically.

f. Selling utilities

What about the argument that it is harder to sell utilities? The problem is not on the demand side; there has been spirited bidding for utilities around the world. The problem is on the supply side, because from the public policy point of view, selling a monopoly firm is fundamentally different from selling one in a competitive market. In the latter case, efficiency losses are unlikely and the public will almost certainly benefit. In the former case, the public may lose if the private buyer exploits the monopoly position by raising prices above the efficient level. Thus utility sale requires putting in place effective regulatory institutions. This is not an easy thing to do. Witness the debacle resulting from the foolish regulatory reform accompanying electricity privatization in California. How do you do it right? That would take another paper of at least the length of the present one, so I will confine myself to the cautionary note that it must be done.

6. Conclusion

In recent years, Egypt has made salutary progress in privatization, and in developing political support for the process. However, the bulk of the positive economic impact remains to be achieved. I wish you every success in exploiting this wonderful opportunity to improve the welfare of the Egyptian people.

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Part II: Discussion

WINNERS AND LOSERS FROM PRIVATIZATION

Participants in the discussion following Leroy P. Jones's presentation included, alphabetically, Abdel Aziz Hegazy, Chairman, Abdel Aziz Hegazy & Co.; Adel Bishai, Professor of Economics, The American University in Cairo; Ahmed Galal, Executive Director, The Egyptian Center For Economic Studies; Fouad Sultan, Chairman, Al Ahly for Development and Investment; Mervat Helmy Tawfik, Project Management of Privatization and Finance, USAID Cairo Mission; Mohamed Reda El Edel, Advisor to the Minister, Public Enterprise Office; Osman M.Osman, General Manager, National Planning Institute; Riham Mohsen, Economic Section, US Embassy; Sameh F.Makram Ebeid, Financial Consultant, Berliner Bank; Sultan Abou Ali, Industry and Economic Consultants.

Prior to the discussion, H.E Mokhtar Khattab, Minister of Public Enterprise Sector gave a brief presentation on the privatization program in Egypt. The following is a summary of his intervention and the discussion that followed.

Mokhtar Khattab: Today's topic is very important, particularly the analysis of the winners and losers of privatization. The focus on losers is crucial for gaining their support to create a favorable public opinion of the privatization process.

Why do we privatize in Egypt? We privatize for pragmatic not for ideological reasons. We have a lot of inefficient enterprises. We privatize them to transfer the management from bureaucratic management into private management. Managerial improvement can be made in many ways. But, the transfer of ownership is the best way to guarantee sustainable change and to improve the performance of public enterprises.

Since we have a lot of losing and distressed companies in our portfolio of public enterprises, we will gain from privatization, as will workers. There may be initial job losses, stemming from the restructuring prior to sale or through reforms that buyers make after privatization. However, in the long run we save jobs because if we don't privatize, all these enterprises will eventually be shutdown.

As our speaker mentioned in his presentation, if we sell profitable enterprises, the number of winners will be limited. Privatization will be just a change of management for better efficiency and other improvements. But, when the number of distressed and losing companies is many, consumers and other players will gain more from privatization.

In Egypt, we have many losing companies. According to the financial results of the year 2000, we have 66 losing public enterprises. Their losses exceed half their equity, which according to the law means they should be liquidated. For practical reasons, however, we do not do that. Instead we restructure them in particular ways to prepare them for privatization. We restructure them financially through debt settlement with the banks. We undertake labor restructuring through the early retirement schemes. We also redeploy the old machines from one firm to another, or sell them for very low prices or free of charge to the workers, to create small units to absorb some of those workers. We also give workers part of their compensation, so that they can use it as working capital.

In terms of achievements to date, we have sold 183 enterprises and factories. The sale proceeds reached around L.E 13.8 billion. We still have to privatize the remaining portions of government shareholding in some of the sold companies. We privatized at the beginning of the process through the stock market but we intend to sell the remaining firms mostly to strategic investors, to create real private owners and avoid diluting ownership among thousands of shareholders. This is of particular concern in industrial companies engaged in sophisticated activities.

Our privatization program is ambitious. But offering a company for sale does not necessarily mean that we will sell it because selling to a strategic investor is a very sophisticated and complicated process. Also, in order to succeed in our program we purposely offer a large number of companies for sale, in order to be able to achieve our goal by the end of the year, which is around 20-30 percent of the offered companies.

Participant: As I understand it, your analysis of the winners and losers from privatization focused mainly on the micro level effects. I think it is important to evaluate the macroeconomic effects too, especially on growth, employment and investment. This point is particularly relevant to Egypt because privatization has been part of a larger reform program.

When you privatize and the government withdraws from investment activities, if the private sector does not invest enough, it could have negative rather than positive effects. Also, the rate of growth of the economy might drop, which is not necessarily only a result of privatization. You have to look at the other components of economic reform and their impact on the economy as a whole; otherwise, you will blame privatization for things it is not responsible for. I think the interaction between the micro and macro effects of privatization is very important, and the outcome could be positive, negative or zero, either because of privatization or other factors. So you cannot come to the general conclusion, that privatization will be to your benefit or loss unless you look at the other factors.

Secondly, with regards to Egypt the depth of the privatization process is important, not just the fact that 183 enterprises have been privatized. I think the actual number of fully privatized companies is fewer. As we are all aware, if the government owns more than 25 percent of the shares of a company, then the company is managed as if it is a public sector company. Therefore the efficiency of this partial effect of privatization cannot be measured unless the depth of the privatization process is taken into account.

Speaker: I very much appreciate your comments, and I apologize for not addressing the issues raised because of a shortage of time. In response to your first comment, that one has to assess privatization in the context of other economic policy reforms, this is absolutely correct. This is why I referred to the counter-factual chart. In assessing the change in the performance of a firm and the extent to which these changes are due to actual privatization, it is essential to assess other factors, such as changes in prices, demand, recession, etc.

To assess the macroeconomic impact you have to do projections like the ones I did. According to the example, if you are going to make gains of L.E. 11 billion, then assess what the macroeconomic impact of that number per year of welfare gain will be. These are not taxes. You are not collecting money from people and giving it to others. This L.E 11 billion is a bonus, an efficiency gain. Next, assess what the macro impact of another L.E 11 billion in the economy will be; adjusting to other things you can measure. For example, take an ICOR and translate it into a change in the growth rate, translate that into rural schools, health, etc. This is a very important extension, which I did not do, and I'm glad you raised it.

The minority shareholding of an enterprise is very important in two respects. Firstly, a change in performance and success will not be achieved without a change in behavior. Secondly, if the government has 25 percent and the rest of the shares are distributed on the stock market across 10,000 people, the performance will be the same without a change in behavior.

There are ways of getting around this problem. When selling minority shares, the government could sequester its shares through some legal mechanism, so that the private sector actually has the majority of the voting shares even if the government maintains a minority. This is what Mexico has done for example.

Participant: I think this was an excellent presentation, particularly as it focused on losers versus winners. However, I think the real purpose or objective of privatization, especially in a country like Egypt, is to basically transform the economy into a market economy and allow the private sector to take the lead.

If this is the case, the technical issues, such as the valuation of enterprises; the mechanisms used to privatize; measuring exactly who will gain and who will lose, while neglecting the macroeconomic implications; and questions of how to compensate the loser etc., are all reasons behind the slowing down of the privatization process in Egypt. Also, because the government sold the profitable enterprises at the beginning of the program it is now stuck with the losing companies, which are very difficult to sell. The Central Auditing Agency also values the firms at very high prices and expects people to be foolish enough to buy them, based on the idea that they can improve them and then make profits.

If the government and the nation as a whole intend to do whatever they can to invite the private sector and entrepreneurs to come in and do the job, then it does not matter whether a company is sold for L.E 100 million or L.E 10 million. The other issue that needs to be dealt with is the existence of the pre-conditions that have to be met by the potential buyers, for example, not firing workers. Why would a buyer be interested in buying such enterprises?

Finally, there is the expectation gap between the government and potential buyers. The government expects to make gains from the privatization process while potential buyers expect to come in and buy the enterprise for its book value. This creates a big gap between the buyers and the sellers, which has to be solved, if privatization is to proceed and if the government is to accomplish its plans.

Speaker: I think your first point is that I should have made this talk in 1995, when Egypt was still trying to build a political consensus. One of the things I have learned in the past few days is that you have already done many of the things I have been talking about. You have maintained a political consensus in favor of privatization by doing a lot of the things suggested here. So I apologize if I am a little late.

One of the things you said is very important, that is, to invite the private sector. This reminds me of something that was said, regarding the number of companies being prepared for sale every year, and that only a quarter of them will actually sell. To avoid this problem, it may be desirable to offer the private sector a range of companies to choose from. If there are for example, 60 companies that we think are ready for sale, talk to the private sector; ask them to tell you what they want to buy. Poland in particular did well with that approach. The person in charge of privatization over there said that he was astounded at the results of initiating that policy. The government said, 'we are the bureaucrats, we do not know which enterprises you guys want to buy, so you tell us.' People were coming in with all sorts of ideas. Not all offers were good offers. So you do not simply accept all that comes your way, but at least you invite the private sector to initiate putting things on the table. This is a partnership between the government and the private sector.

Participant: As far as the welfare consequences of the Egyptian privatization experience is concerned, I would say that much of its success is derived in principal from the adoption of the cost and benefit approach in your book titled "Selling Public Enterprises." The Egyptian program has taken into consideration all the parties involved, consumers, workers, competitors, buyers and government, all in one package.

I disagree with those who believe that the privatization process is slowing down. I believe that the current rate of privatization is normal, taking into consideration the conditions of the economy. In the mid 90's there were high expectations, which helped in selling the public enterprises, and there was a rationing in the selling of those shares. Nowadays, we are in a sort of a recession, and in a recession demand is low, because the prices of the assets are low. The recession affected the privatization process, through creating pessimistic expectations that I think could be reversed in the short run.

Policy makers also adjusted to different situations. When the expectations were high, the sale of the enterprises was done through the stock market. But since the expectations are now down, they sell to private or strategic investors.

Finally, I'd like you to elaborate more on the time dimension in your analysis. In the short run a consumer may lose, but in the long run he might gain, which makes the distribution of gains and losses more realistic.

Speaker: I guess you are right when you say that Egypt has been a success. I have heard today several responses to the kinds of concerns I was addressing, especially in terms of building and maintaining a sustainable political coalition by paying attention to the interests of workers, consumers and others and making sure that nobody gets hurt too badly. But there is still a lot of work that needs to be done.

Regarding the question of selling in a recession, if I may, I disagree with you. For example, if last year when the economy was good, I had a partner to whom I was selling an enterprise, but there was no deal. Now we come back and talk this year in a recession. Is it convenient for us to make a deal? If we are both rational, the answer is no. Why? Because the value to him is going to go down, and the value to me should be going down just as much. Only if he can turn the enterprise around, do we have room to make a deal. But why doesn't it work for the public sector? The answer is, if his valuation goes down mine doesn't, the government may not agree on correcting the prices to reflect the drop. Therefore, the government needs to adjust its prices to reflect reality, although the basic economics has not changed. If the numbers have changed and the basic economics have changed, then the opportunity for sale is still there as long as he can run the firm better than I can.

Regarding your question on the time dimension, let me answer it by looking at different actors. For the government, although everybody thinks that the government benefits are the proceeds from sales, which happen up front, these benefits actually come third in terms of the total. The biggest gain is the decrease in subsidies and the increase of taxes, which happen after the enterprise is turned around and the behavior changes 3 or 4 years later. The same holds true for the benefits to the buyers. They also don't make money, until the enterprise is turned around. The same goes for the consumers and workers. Probably, the only group that is affected adversely right away is the workers, who are laid off.

In the study I presented today, the benefits are not merely identified over a short period of time but are extended into the future. It is more like a project evaluation, where the variations and the extremes of the benefits and the costs are taken into account.

Participant: I have three comments. First, I think the point you mentioned on the gains from privatization, the L.E 11 billion in your example is very interesting. I think it is crucial for everyone present here today to understand it. So I'd like you to go back to this point, and explain more how we can generate this amount in perpetuity. I think when people think of privatization here they think of the sales price.

My second point concerns the banking sector. The point we are debating today in the market, is whether to sell them or not. This is our national heritage, our patrimony, do we sell them to foreigners to dominate us, or do we turn them around into profitable organizations?

My final point is related to Greenfields. The private sector are wondering why they should buy a public sector company burdened with excess labor and other problems, when they can go into a Greenfield, and get a 10-year tax exemption in a new city. Therefore, the government must consider all these questions in its calculations of whether to privatize or not.

Speaker: Well to describe how you get the L.E 11 billion would take some time. But the most important thing is the change in behavior we keep talking about. Let's go back to our example on the simple transaction between a public sector company and a buyer. If my partner is going to run the company better than me, this means he is going to generate more money. Think about a simple calculation, let's say the public sector is 20 percent of GDP, and my partner can improve efficiency by 5 percent. Taking into consideration a few other things that will happen in privatization, the total gains will be something like L.E 8 to 10 billion. Therefore, a very small change in efficiency for a large segment of the economy can generate huge gains. People do not appreciate that. I guess this is your point and I agree with it. Also, particularly in the government sector, people look at the gains as being the proceeds from privatization. That is not "peanuts," but it may only be 15 or 20 percent of the real gains to the government.

On the banking sector, I refuse to comment. I'm very brave, and I can almost talk about everything in economics, except the banking sector. It is very complex. I have worked a lot with countries in East Asia. I have seen the cost of bad privatization of the banking sector and deregulation. The banking sector is a really dangerous thing to mess around with, but that obviously doesn't mean you shouldn't reform it.

The private sector pushing the public sector out is a very interesting point. It is not necessarily bad, though it is of course bad for the government. However, if you think about China, it happens there everyday. They have not done much privatization but companies go out of business everyday as a result of the rise of the private sector. This is certainly a second best solution to privatization.

In response to your last point, should the private sector buy my public sector company that was built with Russian technology in 1920, that is over burdened with workers? Or would it be better for the country to put the money and entrepreneurial management talent into a new company? In some cases, the private sector and the country may gain more by turning that company around, than by putting money into a new company. Which option is the best depends on the price this company is selling at, which is based on a realistic agreement in setting the price.

Participant: I guess the main problem with the privatization process we have been seeing here in Egypt is the reservation price or the floor price. As you mentioned before, in the negotiations between the buyers and the sellers, there is always a price that you can agree on, if the government is willing to be realistic about it. You have also mentioned the change in the business environment that should be taken into account relative to other countries. If you have improved, but Dubai for example is improving much faster, you are still worse off.

The government should also be willing to accept the fact that it can sell something below its book value, or even at a negative price, if it is actually a losing company. I think it is time to sell this idea to the public and to parliament, so that the government official engaged in the sale is not always accused of being corrupt.

Speaker: I can only agree with you on the economics. Your point is 100 percent correct. But politicians do not always pay attention to economics. There is a good reason for that. No minister wants to see the headlines in the news "the Minister gives away the national patrimony." But there are tricks to use, to get the value of the firm up. To minimize the political opposition you can, for example, clean up the balance sheet. If you can tell me how to persuade a politician to sell at a negative price, I'd support you. I don't know of a country that did that.

Participant: In your assessment of the gains and losses of privatization, I think you excluded a very important segment in our society, which is the majority that is either living around or below the poverty line. So don't you think that using the privatization proceeds for improving the lives of the poor would build consensus and acceptance for the privatization process?

My second point is that again in a country like Egypt where per capita income is low, and the rate of domestic savings is also low, one should not expect that the magnitude of domestic savings will be sufficient to meet the needs of privatization. Therefore, one should be addressing oneself to foreign direct investments. Some people look at that as something bad, although we have an investment law, enacted since 1974, which encourages foreign investments. Therefore, I think foreign direct investments and the role of multinationals in privatizing the big companies, utilities etc., can be extremely beneficial. In such a case, there should be a strong, legal regulatory framework, as the speaker mentioned in his presentation.

Otherwise, we will be just switching from a public monopoly to a private monopoly. Because regulation can be extremely difficult, we can make use of foreign expertise. The World Bank has been great in this respect.

I do not agree with the idea of using the privatization proceeds in restructuring companies. There is a big difference between financial restructuring, cleaning up the balance sheet, as mentioned before, and the restructuring required to put a company on the right track to start making profits. Given that these companies were unable to improve their performance in the past we should not use part of the proceeds to restructure them.

I do not agree that privatization has been extremely successful. I believe the companies that have been privatized so far are not doing so well. Ownership has been diluted, and the technology or the management skills required to improve efficiency and penetrate foreign markets have not been obtained. A mixture of foreign capital and domestic capital in my opinion is badly needed. But when it comes to FDI, you find that the viability of the project itself is not the crucial element in buying. It is the overall investment environment, the business environment, the legal and regulatory framework governing the business, the tax rates, and labor skills that matter. A lot of reforms are needed to stimulate and convince, not only foreign capital, but also Egyptian capital. As mentioned by one of the speakers, privatization is an element of the economic reform program. It is an element in a chain of changes that is required, in order to allow those important elements to succeed.

Finally, I do not agree that selling in a recession is not good for the country. I guess if it is a good time for imposing new taxes, then it should be a good time to privatize.

Speaker: Regarding your point on the restructuring of companies, I'll go back to the same transaction. If I'm selling this company and I ask myself, should I spend $1 million on renovating the company before selling it in the hope of getting $2 million more in price? I believe that outcome is very unlikely, because I'm a bureaucrat, and I'll be spending a million dollars doing what the buyer could do for $500,000. This means, speaking as the government, I'll lose $500,000. On that point I agree with you.

On your first point, that I excluded a critical group, the poor, this is always a problem of the public enterprise sector. Public enterprises, here as elsewhere, are defended on the grounds of helping the poor, and that they care not just about the profits but about the poor. Let me ask a question? Take the lowest paid workers in a public enterprise. Where are they in the income distribution in Egypt? I am willing to bet that they are not the poor. If you want to help the poor, you make public enterprises more efficient, you generate funds, which then go to the government. Or you give money to the ministry of health, rural clinics, rural roads, rural education. These are the ways in which public enterprises can help.

To answer your question on privatization, the number I got is extra money for the government. What are they going to do with this money? Some of it will go to restructuring, the rest will go to the things you have mentioned. Therefore, it is not something I left out, it is just a sub-category of what the government does with the money. It is also a way to show how privatization can be used to help in public purposes.

On foreign capital, I think you are absolutely right. As we move forward, this is going to become more and more serious. In terms of the opportunity cost, that one of the discussants mentioned, you have to look at what is going on in other countries relative to Egypt. It is a tough market, and a lot should be done here in Egypt in this respect.

Participant: Whether we like it or not, the workers and social stability are important components of the government's social objective function. We can't ignore that, especially in a developing country like Egypt, which has a lot of strategic labor-intensive industries, such as textiles. In the examples our speaker gave, the workers were better off, or at least they were not worse off. In these cases the government can buy off the workers. In Egypt, the situation is different. We have industries burdened with workers. Also, the government does not have the resources needed for all these workers. Some observers say that these are the costs of privatization and economic reform and we have to move on. The government, on the other hand, does not want to move on. So we are stuck in a dead lock. How do you address this problem?

Speaker: When I was flying into Egypt two nights ago, I was asking myself the same question. But if excess labor here is 20 percent, this is not so bad. You have people leaving all the time, women get pregnant, and people retire or die. If over and above you are growing at a reasonable growth rate, with natural nutrition and the demand for new workers, in a year and a half you do not have those excess workers. Some people say that it is significantly higher than 20 percent, so it is a bigger problem. But I find that somehow you have done it. I presumed that at this level of success, you would probably have the unions out there screaming. However, here I can tell they are not.

Participant: Here you are talking about the tier 1 companies, or the better tier 2 companies. We are now moving towards the worst companies that should either be liquidated or closed. But liquidation is difficult as there is a large number of excess labor that you wouldn't want on the streets. Even a restructuring fund won't be able to accommodate all these people.

Participant: I don't think the problem is as bad as this. If you look at the total number of people employed in the public enterprise sector, compared to a labor force of something like 18 million, the total number of employees in the public enterprise sector is around 1 million. So, you are not talking about big numbers. The real problem is in the government civil service sector, not in the public enterprise sector.

Now take the 1 million employees in the public enterprise sector, and make the worst assumption that around a third of them are made redundant. This translates into about 300,000 employees. Take this number and multiply it by an average of the salaries over a certain period of time. The result is manageable for two reasons. First, the implementation will be spread over a number of years. Second, part of the proceeds from privatization can be used to compensate them. The real issue then is political. Because workers are organized, they can create problems. This didn't happen so far. Can it get a little bit more difficult as we move down the road to the enterprises that are more labor intensive, and redundancy is higher? Probably not, given the order of magnitude I talked about.

Speaker: I think your concern is very valid, and I know a lot of countries that have not taken this into account and consequently the privatization program stopped. If you do not deal with those kinds of concerns in a country, you have a problem.

Participant: Firstly, I would like to praise the Egyptian experience in terms of always taking into consideration the interests of the different groups. However, I do not praise the Egyptian experience in terms of explaining the issues clearly via the media. Until today, some people do not understand what privatization is. We need to do what England did 20 or 30 years ago on the British TV. They aired a 5 minute chat on economics to explain in simple terms that privatization is not what people quoted earlier as, "selling the country to foreigners…," and that the people can be part of it simply by owning shares. Education on the subject is vital and it is time that Egypt took such steps. We can always learn from previous experiences, but we have to continuously explain things to the people.

Secondly, our speaker spoke of regulatory bodies. Looking again with an eye into the future, we really need to study regulatory bodies, and how they function before we continue with the program. In many instances we privatized without having the regulatory infrastructure or even the commercial laws etc.

Thirdly, regarding Greenfields, I think an important example is the extreme that China has been following. I would say that Egypt has a lot to learn, now and in the coming years, from

China in the way China negotiates FDI. As our speaker mentioned, privatization should not be viewed in isolation. It is important to look at the export sector and the institutional setting etc. Also, it is important not to view tax holidays as the attraction for FDI. Proper institutional setup is the attraction for FDI.

Regarding the banking sector, I agree with the speaker that it is a tough issue. When it comes to the idea of public sector banks, it is not the idea of selling them that poses the problem. After all, we had private sector banks in the past. The real issue is that the economy will not operate well without a proper financial sector.

Participant: I guess until the criteria for evaluating the privatization performance in Egypt has been stated we cannot talk about the results. The general feel of success is based on the belief that something is going on. The question I'd like to ask is: What is the impact of privatization and economic reform on the Human Development Index (HDI), as one of the main objectives of any economic reform? In other words, what is the impact on the people? As I understand the results show that our HDI is declining. However, I cannot tell whether it is a result of other reforms or of privatization. I think we should look at the impact of all reforms. Additionally, I was actually surprised when it was mentioned that the government's plan in pursuing the program is not based on ideology, especially since we are in the phase of transformation from a socialist economy to a market economy.

Privatization is about creating a class of entrepreneurs. I think all participants would agree with me that in Egypt we see a monopoly of entrepreneurs by name. I would understand that the policy of privatization in a country like the UK is to expand ownership. But here in Egypt have we really succeeded in creating that middle class of entrepreneurs? Even in micro-credit enterprises, although it is talked about, I do not think we are doing much. When we talk about privatization, we talk about the locals, the nationals, and the foreigners. I really doubt that the foreigners have participated much in privatization or in FDI. Everybody knows that 35 percent of the transfers are Egyptian, 10-15 percent Arabs, 10 percent European and very little from the US. Regarding foreign investment, we still need more. However, the problem is that about 20 or 25 people are running the whole show in a capital market economy.

Finally, one has to understand the history of the public sector in Egypt before attacking it. Bureaucracy is still affecting everything and therefore one should look at the economic and social environment in Egypt.

Participant: Assessing the Human Development Index within the process of privatization is a very tough issue. I'll therefore refer you to the five volumes of the human development reports since 1994, which look at the impact of economic reform on poverty.

Speaker: Your comments are putting the whole thing in a much broader perspective. Privatization as one package of economic reform is not going to reduce poverty, it is linked to poverty through the government revenue and the way that it is spent. If you generate more taxes and fewer subsidies, you have more money to spend on all the other things.

With respect to the use of words, "creating an entrepreneurial class." I would think that the UK created an entrepreneurial class by selling British Telecom to a million people, who hadn't invested before. What they did is expand a capitalist middle class, which is a good thing if you believe in capitalism, but it is different than creating an entrepreneurial class. You do not sell biased companies on your first entrepreneurial act. SME's is a different package of policies and I don't think that privatization is going to do much to support this goal.

Participant: One of the things I believe is really impressive about this meeting is that people are no longer asking the question of whether we should privatize or not, which would have been the case a few years ago. Today people ask how we should privatize. I find it remarkable that our only exception is the banking sector.

There is a consensus on the issue that it is not the act of privatization itself that does the trick, it is a package, a combination. It is the act of coordinating different policies, and institutional arrangements and it is how you do this that makes a difference. This can be seen from international experience as well as from our own experience.

The last point, which is a very important conclusion, is that we have a long way to go. We have done 20 percent of what we need to do; we still have a remaining 80 percent.

LIST OF ATTENDEES

Abdel Aziz M. Hegazy
Chairman, Abdel Aziz Hegazy & Co; Former Prime Minister

Adel A. Bishai
Professor of Economics, The American University in Cairo

Ahmed Abu Shadi
Director General, Cairo Center for Economic Information

Ahmed Farid
Managing Director, Alkan Telecom

Ahmed Farouk Ghoneim
Economist, Cairo University

Alaa A. El Seesi
Vice President, H.C. Securities & Investment

Alaa Abou Allam
Senior Advisor, Arab Contractors

Ali Dergham
Advisor to the Minister, Public Enterprise Office

Amgad Abdel Ghaffar
Director of International Affairs, Ministry of Foreign Affairs

Anthony S. Cahn
Supervisory Program Economist Sector Policy, USAID

Azza El Shelbiya
Economist, Ministry of Economy

Borham Mohamed Atallah
Professor of Law & President, Atallah Law Office

Dalia Abou Samra
Economics Department, German Arab Chamber of Commerce

Dalia Wahba
Communications & Development Director, Community & Institutional Development (CID)

El Bayoumi El Samanoudy
Director of Economic Studies, Egypt's Electricity Holding Company

Eman El Ayouty

Fiona Moffitt
Correspondent, The Economist Intelligence Unit E.I.U

Fouad Sultan
Chairman & Managing Director, Al Ahly for Development & Investment (ADI)

Friedrich Kramme- Stermose
Resident Representative, Friedrich Ebert Stiftung

George Mina
Counselor, Embassy of Australia

Hager El Istanbuly
Assistant Minister to North America Affairs, Ministry of Foreign Affairs

Hanan Kheder
Senior Economic Advisor, Ministry of International Cooperation

Heba Saleh
American University in Cairo

Hisham A. Fahmy
Executive Director, The American Chamber of Commerce (AMCHAM)

Hussein Sabbour
Chairman, Sabbour Associates/ Al Ahly Real Estate Development Co.

Ingy Tawakol
Journalist, Akhbar Al Youm

Ismail Shoukry
Vice President, H.C. Securities & Investment

Jilan Magdi
Journalist, Al Ahram Hebdo

Khaled A. El Kafrawi
Privatization Specialist, Ministry of Economy NA Foreign Trade (MOEFT)

Laila El Khawaga
Professor of Economics, Cairo University

Lobna Abdel Latif
Professor of Economics

Loutfallah Imam Saleh
Executive Director, Ministry of International Cooperation

Magda Assaad
Business Development Manager, Integrated Development Consultants

Magdy Rady
Director, Economic Information Sector

Mahmoud Chawki
Managing Director, Telecom Engineering

Manal Henawy
Economist, Ministry of Economy

Medhat El Akkad
Ministry of International Cooperation

Mervat Helmy Tawfik
Project Management, Privatization & Finance EG/PF, USAID Cairo Mission

Mirette Mabrouk
Managing Editor, Business Today

Moatassem Rashed
Social Fund for Development

Mohamed Al Sheikh
Journalist, Al Allam Al Youm

Mohamed Gamal El Din El Bayoumi
Assistant Minister of Foreign Affairs- EU Partnership Unit, Ministry of Foreign Affairs

Mohamed Reda El Edel
Advisor to the Minister, Public Enterprise Office

Mokhtar Khattab
Minister of Public Enterprise Sector

Mostafa Abd El Latif
Senior Manager. Investment Banking, Pricewaterhouse Coopers

Nagwa Aly Khashaba
Professor, Faculty of Commerce, Suez Canal University, Ismalia

Osman M. Osman
General Manager, Planning Center, National Planning Institute

Paul B. Smith
Privatization Consultants, Carana Corporation

Racha Mohamed Hanafi
Journalist, Al Ahram Hebdo

Rasha Omar
Researcher,Evaluation & Financial Analysis, Public Enterprise Sector

Riham Mohsen
Economic Section, US Embassy

Robert Springborg
Director, American Research Center in Egypt

Sameh F. Makram Ebeid
Financial Consultant, Berliner Bank

Sherine El Shawarby
Economist, The World Bank

Soheir El Sherif
Economist, TAPR

Sultan Abou Ali
Industry and Economic Consultants (IEC)

Tim O' Hara

Tyler Holt
Privatization Advisor, USAID

Yasser Sobhi
Journalist, Economic Section, Al Ahram Newspaper

Distinguished Lecture Series

Egypt has made salutary progress in its privatization program and in building political support for the process. Once debatable, privatization is now seen by most Egyptians as a necessary and positive step for achieving economic progress. However, the process has recently slowed down. In addition, no ex post assessment has been made to estimate its impact on consumers, workers, the seller and buyers.

In this edition of the DLS, Leroy P. Jones offers insights about the likely winners and losers from privatization and the conditions under which these benefits can be maximized. His views draw on his vast experience and a landmark study on the welfare impact of privatization, covering diverse sectors in five countries. The basic conclusion of this study is that privatization is capable of producing a win-win situation provided certain conditions are fulfilled. These conditions include a transparent sale process, competition, and appropriate regulatory regimes in the case of selling utilities. Jones further argues that the speed of privatization could be hampered by exaggerated reservation pricing and extensive restructuring prior to sale. These insights are particularly relevant as Egypt moves to the privatization of loss-making enterprises and utilities.

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