

**Discussion Paper No. 2**

**State Ownership:  
A Residual Role?**

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# STATE OWNERSHIP: A RESIDUAL ROLE ?<sup>1</sup>

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## Abstract

In this paper we review the state of thinking on the governance role of state ownership. We argue that a gradual transfer of operational control and financial claims over state assets remains the most desirable goal, but needs to be paced so as to avoid regulatory capture, and in first instance the capture of the privatization process itself. In addition, the speed of transfer should be timed on the progress in developing a strong regulatory governance system, to which certain residual rights of intervention must be vested. In many countries, institutional weakness limits regulatory capacity and reliability, yet our conclusion is that in such environments maintaining state control undermines the very emergence of institutional capacity, and so the balance should tip towards progressively less direct state control.

After all, what are “institutions” if not governance mechanisms with some degree of autonomy from both political and private interests ? The gradual creation of institutions partially autonomous from political power must become central to the development of an optimal mode of regulatory governance.

We advance some suggestions about creating maximum accountability in regulatory governance, in particular creating an internal control system based on a rotating board representative of users, producers and societal organizations, to be elected by a process involving frequent reporting and disclosure.

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## **Introduction**

In this paper we review the state of thinking on the governance role of state ownership and offer some new directions and recent developments.

A sweeping nationalization movement took place starting from the First World War in Europe, as public demand for greater social control over markets followed a series of devastating financial crises (hyperinflation, the 1929 stock market crash, banking crises) and the Great Depression, a process continued in some countries after the second world war. In addition, decolonization created many new independent states eager to engage in nation building and promote development.

Yet the post-war experience led to a drastic rethinking over time. Evidence confirmed the inefficiency of state owned enterprises, questioned the motives of politicians in establishing direct control for regulatory purposes and challenged the social equity of favouring specific constituencies at high public costs.<sup>2</sup>

In response, in the last two decades a massive privatization process of productive and other activities previously considered public services has taken place across the world. Privatization in developing countries has been spurred since the IMF and the World Bank started to make their assistance conditional on privatization.

After twenty years of this process, the borders of state ownership have been dramatically redrawn in many countries. The process has unquestionably been quite successful overall (Megginson, 2002). Yet the experience of privatization applied to certain sectors or countries has ultimately raised objections and resistance even among early and committed proponents, who find that privatisation in some contests creates serious risks (Nellis, 1999), which we interpret as the result of public capture of the process. While

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<sup>2</sup> The debt crisis in the eighties was also a catalyst which forced governments to divest loss making operations to generate revenues. As Laeven and Perotti document (2002), privatization tends to be initiated at times of economic difficulties.

privatization has yet to run its course in many countries and sectors, recent experiences in Latin America and Eastern Europe requires that we seek to understand better its limits.

To discuss the relative merits of state and private ownership we thus review the fundamental literature on ownership, discuss the main drivers of political decision making and draw some conclusions on what role state ownership or more generally public governance does and/or should play in regulating economic activity. Section I introduces the issues. Section II reviews the broader conceptual framework. Section III presents our views.

## **Section I**

SOEs exhibit a significant lower productive efficiency (as distinct from allocative efficiency) in comparison with privately owned counterparts.<sup>3</sup> The main causes have been traced back to a general lack of accountability,<sup>4</sup> leading to

- a) a lack of managerial and employee incentives to efficiency
- b) problems of competence or corruption by state authorities
- c) the use of SOEs for political purposes, in favour of favoured constituencies

Boardman and Vining (1992) also concluded that SOEs may undermine the existence of private competitors.

There are striking parallels between the governance problems caused by state ownership or by diffuse private ownership. The free rider problem applies to taxpayers even more so than to dispersed shareholders; moral hazard may be enhanced under state ownership since the powers of government are greater than private management and thus

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<sup>3</sup> We will not review empirical findings on the efficiency of privatization across countries. Good surveys are found in for instance in World Bank (1995), Megginson et al (1994), McKenzie and Mookherjee (2002), and Boubakri and Cosset (1999).

<sup>4</sup> We mean accountability to citizens, not investors. While SOEs are incorporated firms, they have no scrutinizing equity market investors; nor do lenders play a disciplining role, as SOE debt is perceived as a public obligation.

harder to control (Perotti, 1994); and limited disclosure is probably a greater problem in state than in private companies (Vickers and Yarrow (1989)) in the absence of institutions empowered to audit state decisions.<sup>5</sup>

Two arguments are used for justifying state ownership in the presence of market failures such as market power or externalities (see e.g. Esfahani and Ardakani, 2002). The first (which we term the ‘public commitment problem’) concern the inability of a sovereign government to commitment to market-friendly tax and regulatory policies, which discourages private investment and may result in direct government involvement in production as a substitute. The approach takes the view that politician have difficulties to credibly commit to refrain from tax and regulation manipulation to collect quasi-rents. For instance, state control of infrastructure may be the result of the unwillingness of private investors to fund large ex ante investments whose rewards, once sunk, are subject to political decisions. The second (which we term the ‘private commitment problem’) identifies the difficulty for regulators to control significant decisions by private owners, unless government has direct control over the enterprise [see Hart et al. (1997); Shleifer and Vishny (1994)]. For instance, state ownership of banks may arise because private banks take advantage of depositors (as in Russia) or of deposit insurance.

In the public commitment approach, the inability to commit arise from sovereign authority (the monopoly of authority) and may lead to inefficiency when coupled to biased preferences and/or political opportunism, leading to corruption, excessive spending or targeting of benefits, which in turns induce excessive taxation or interference.<sup>6</sup> In the private commitment problem, the difficulty to impose certain rules on private enterprises may be due to poor institutional mechanisms to control private behaviour indirectly and thus justify direct state control. Yet a failure to impose political

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<sup>5</sup> In fact, we will argue later that the most neglected benefit of privatization is the increase in public scrutiny arising from the fact that political control becomes exercised more at arm-length, or in any case through explicit legislation, so that its goals become more open to public opinion. This is comparable to the case of a firm with many owners obtaining a public listing, a move which improves the quality of information available to judge its management.

<sup>6</sup> Perotti (1995) argues that under uncertain public commitment, governments can credibly inspire confidence by transferring control immediately while selling ownership gradually, signaling its commitment to privatization policy by its willingness to bear residual risk.

wishes on the private sector does not imply that such goals are socially, as opposed to politically, desirable, nor that the state as an owner would perform better.

Both these approaches, which try to formulate a rationale for the “optimal” size of state ownership, presume that state authorities seek to correct market failures such as externalities, natural monopolies, high information costs or public goods. Their justification for government ownership depends critically on this assumption. Yet rather than assuming such a public objective, it is more useful to discuss circumstances and governance forms under which there is enough public scrutiny by citizens to ensure some congruence of political intent and public welfare.

In general, limited commitment applies for both private individuals and state authorities under incomplete private contracting and its public sector counterpart, incomplete legislation. The critical difference is that the sovereign state has greater discretion and thus greater scope for abuse. The main argument against state control arises from the combination of broader discretionary powers and the potential for political opportunism.<sup>7</sup>

We will argue that privatization and open regulation is not only needed for productive, but also for allocative efficiency, since it is essential for democratic control over the regulatory process. At the same time, we recognize that privatization does fail to deliver much of its potential in poor institutional contexts, and specifically, whenever it is difficult to establish regulatory control leading to private commitment to specific goals of social relevance. Even in such context we argue that at most only a temporary form of partial ownership with highly contingent control rights can be justified, based on an

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<sup>7</sup> Given that many developing countries have weaker institutions constraining public abuse, the case for state control is particularly difficult precisely in those contexts where the need may be in principle is greatest. Yet the right goal in a dynamic contest should not be between state or private ownership, but rather to dedicate the task of state control to be the gradual build up of the institutional framework, which would allow a greater separation of direct political control from productive decisions.

explicit agenda for building up over time institutions, which can take on the regulatory task on a more autonomous basis.<sup>8</sup>

Thus in our opinion, the relevant notion of non-private governance needed is **regulatory governance**. Regulation needs to be explicit, and thus exposes both public policy and private behaviour to greater public scrutiny. To function properly in poor institutional context, however, the regulatory institutions need to be developed progressively. We will argue that a more grassroots form of governance concept needs to be recognized, creating legitimacy and scope for progressively more independence from the executive branch of government.

Regulation fails just as privatization does, namely when it leads to regulatory or (in the extreme cases) to state capture. Good examples are large privatization programs in Chile in the late 1970s, in Mexico in the 1980s and in Russia in the mid 1990s. In some early Latin American privatization programs, large private investors were grossly favoured on the privatization of the large state banks, which were sold on the cheap and on highly leveraged terms. This enabled these investors to fund the acquisition of control over a number of privatized firms. In all these cases, the abuse of bank resources for private purposes led to brutal financial crises, which forced renationalization of most of these grupos. The Russian experience is also instructive in how captured privatization programs can undermine the authority of the state and other institutions (see Perotti, 2002). In contrast, the Chinese experience of gradual privatization of the economy by favouring entry while retaining control over the process has limited private capture of the process, although it still leaves some uncertainty over the path of gradual retreat.

## Section II

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<sup>8</sup> The exception should be those circumstances when loss of state control would lead to uncertainty over the allocation of ultimate control and enforcement. This is evident in the case of executive powers and public security, as in the case of the army, the police or the prisons.

Do politicians maximize social surplus ? This is the same as asking if politicians in office represent the interest of the electorate or their own interests. Alternatively stated, the question is whether political markets function efficiently.

Both Sappington and Stiglitz (1987) and Hart et al (1997) show that under the assumption of a benevolent (“helping hand”) government, market failures may be addressed by state control.<sup>9</sup> Sappington and Stiglitz (1987) present the classic argument for state control. They argue that information, contracting and bargaining costs limit the government’s ability to regulate by *ex ante* design. They also suggest that when the government cannot exactly determine its objectives (or wants to change its mind in the future!) due to lack of experience, it may want to retain direct control to avoid costly contract renegotiation procedures with private parties.<sup>10</sup> To the extent that intervention has large costs, state ownership (or rather, state control) is to be preferred to private ownership.

Hart et al (1997) adopt a model in the spirit of Coase (1937) on the decision to buy an input on the market or to produce it in-house.<sup>11</sup> The government must provide a ‘basic’ good and can either hire public employees, led by a manager, and retain ownership of the assets, or sub-contract with a private supplier with his own employees and assets. The ownership of the assets grants the stronger incentives in an incomplete contract world. The provider of the good can invest time to improve the quality of the service or to reduce its cost, at some adverse effect on quality. Neither action is contractible *ex ante*, so each innovation needs approval by the owner of the assets. Private ownership is superior to public ownership when the deterioration of quality from cost reduction is small and the government employees have weak incentives to innovate. Thus even state ownership with a benevolent government need not be the best alternative.

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<sup>9</sup> Other authors in the past have argued that other social goals, such as acceleration of technology transfer, increased employment, reduced inequality, and regional development, may be realized via SOEs [Cholski (1979)]. The evidence on the long term role of SOEs have largely discredited this view, and have shifted attention to fiscal and regulatory alternatives to achieve these goals.

<sup>10</sup> The argument may cut both ways. Schmidt (1996) argues that privatization is a way for government to credibly deny itself private information about production costs, and therefore force the private manager to reduce costs, since subsidies now will reflect social benefits rather than firm costs.

HSV note that even if a large part of the output is non-contractible, private provision may still be superior, because entrepreneurs have the incentive to provide quality in order to build a reputation with customers and regulators.<sup>12</sup>

Both these papers find an echo in the recent literature on “incomplete legislation” which we address later (Pistor and ? 2003).

### **Self-interested government**

A growing strand of the literature take a positive rather than a normative political economy approach to state ownership and assumes that politicians are able to pursue their own interests at the cost of the common good. If selfish politicians lead to corruption and patronage (Shleifer and Vishny, 1993), then SOEs’ inefficiency is due not just to weak incentives, but the result of a deliberate political choice to transfer resources to supporters<sup>13</sup> [Boyko et al (1993); Shleifer and Vishny (1994)]. Such indirect targeting, distorting the productive process, can occur only at some distortionary cost (Bias and Perotti, 2002), such as excessive employment<sup>14</sup> and wages. In addition, SOEs may build plants in economically unattractive regions [Martinelli (1981)]. Other sources of political benefits include the production of goods that are only politically and not socially desirable.<sup>15</sup> Politicians may even distort the regulatory framework ahead of a SOE sale, by reducing future competition, hence maximizing revenues (or bribes) at the cost of consumer surplus.

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<sup>11</sup> There are close parallels between theories of the firm and of privatization [Coase (1937); Grossman and Hart (1986; Hart and Moore (1990); Hart (1995)].

<sup>12</sup> Vickers and Yarrow (1989) and Schmidt (1996) show that the resulting distribution of the surplus need not be efficient.

<sup>13</sup> Which constituency is favored depends on the determinants of political power. The government may favor politically appointed managers, employees or consumers. Although it is sometimes argued that the government will weigh consumer surplus higher than producer surplus when consumers have more voting power (Vickers and Yarrow, 1989), producers (including workers) have more incentive to lobby and thus are more likely to receive political attention.

<sup>14</sup> Even in the U.S., state entities employ typically 20-30% more employees than their private counterparts [Donahue (1989)].

<sup>15</sup> The development of the Concorde plane is a good example (Anastassopoulos, 1981).

Empirically, many SOEs have a poor record in solving market failures. Externalities such as pollution were not visibly better managed by SOEs, such as the environmental situation in Eastern Europe illustrates [Grossman and Krueger (1992)]. Public monopolies often abused their market power not necessarily by high prices but by sheer inefficiency, allowing their employees a “quiet life”, or by granting preferential treatment to political constituencies. This form of internal capture has led to such low rates of investment under state monopoly in many countries. Primary examples are the energy or telecommunication sectors, which often only after privatization and the resulting increase in competition has led to an expansion and modernization of the infrastructure.<sup>16</sup>

Perotti (1994) discusses how privatization reduces the effective control of politicians because it confers residual rights of control to the owners, and thus effectively de-politicizes the decision process. Even when politicians may still intervene to pressure privatized firms, e.g. to retain extra labor, privatization changes the bargaining power of the government: it establishes some restraint as it transfers a set of residual rights to the private owners (Perotti, 1994) who have strong incentives for resisting value diversion. Under concentrated private ownership, the required subsidies to maintain high employment are too high, and the government stops subsidizing the firm. Thus the budget constraint hardens, and restructuring occurs (Boyko et al, 1996).

The next section offers a broad framing of the conceptual framework on the nature of ownership and its implication for private and state control. We start with the accepted notion that ownership is relevant because we live in a world of incomplete contracting and incomplete legislation.

## **Section II**

### **Ownership as Residual Rights of Control**

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<sup>16</sup> It is precisely such tasks that normative public economics would have assigned to a public firm, since private firms would tend towards under investment and under provision of services.

Under complete contracting, any agency issue interfering with optimal decision making can be managed via explicit arrangements which fully describe the optimal course of action. Then ownership is irrelevant, since all actions in all contingencies are already contracted upon. In this case the allocation of ownership issues has no bearing on efficiency [Hart (1995); Sheshinski and López-Calva (1998)]. Any market-driven distortion such as a monopoly power or externalities can be resolved via regulation.

Ownership makes a difference to incentives and thus actions because contracts are incomplete (Hart, 1995).<sup>17</sup> In this context, ownership completes contracting as it assigns to the owner the set of residual control rights over uncontracted or unregulated contingencies. Thus under incomplete contracting there is ambiguity on actual decisions, and control may be assigned to resolve optimally this issue. State ownership is seen as justified when explicit regulation is hard to implement because of non verifiable contingencies. For example, quality of incarceration of prisoners or basic medical care are hard to verify and cannot be easily contracted upon (Hart, Shleifer and Vishny, 1997).

This definition of private property right as a residual set is really quite broad. State regulation is presented here as affine to contracts, under the understanding that the law has to be explicit written down and is thus incomplete. We take issue with this narrow notion. Private ownership only reduces the degree of discretionary control which the state can master over private assets, and only to the extend of constitutional (and even so, effectively enforced) private property protection. Since laws can be changed, the scope for private control may be indefinitely reduced by legislation. in the country. Thus, while very valuable in a static setting, this definition is a bit vacuous when the state can expand its regulatory powers by fiat.<sup>18</sup>

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<sup>17</sup> Contracts are incomplete because of limited capacity to foresee or fully describe future contingencies, or by limited enforcement due to unobservability or verifiability of events.

<sup>18</sup> At the same time, there is some truth to this notion in what lawyers call the elasticity of ownership rights, in the sense that when a regulation is removed, the encumbrance on the property is removed. The extreme case is probably the return to former owners of property in many Central European countries after the fall of the Berlin Wall.

Let us come back to the classic argument for state control by Sappington and Stiglitz (1987). The argument, while sensible, is unbalanced. One of the greatest problem in state ownership, even when originally established for justifiable causes, is that it is most difficult to remove once established. Just as any policy-oriented economist knows, any institution created for a temporary purpose will tend to make it a permanent task. Additionally, politicians have multiple goals besides fair regulation, In reality, it may be dispersed citizens which face the hardest task of intervening in state controlled property to ensure proper governance.

### **Mixed state ownership**

Some authors (e.g. Che (1997)) observing the role that firms formally owned by local authorities, so called township and villages enterprises (TVEs), played in China's growth, argues that government ownership can serve as a commitment mechanism through which the government will restrain itself from rent seeking activities, and even offer support. Yet the de facto allocation of control in the TVEs resembles a private arrangement with involvement of (or direct personal control by) local politicians. It resembles thus a private firm which is able via bribes to obtain access to scarce resources (credit or licenses) as well as worker discipline. Yet this examples refers to productive activities in highly competitive sectors, and thus holds little promise to address the issue of market failure.

A case for temporary mixed ownership is given in Perotti (1995). Under uncertain public commitment, governments can credibly inspire confidence by transferring control immediately while selling ownership gradually, signalling its commitment to privatization policy by its willingness to bear residual risk. A parallel argument may be made by arguing that the public sector should keep control over the decision rights until proper regulation is in place (in the language of Stiglitz and Sappington, until the state learns about its own objectives). In both case the argument is for temporary, gradually decreasing residual cash flow /control rights. Once ownership is indeed decomposed in these two components, the development of an autonomus regulator framework is just another name for this process. But how to govern the monitor ? In other words: how to

establish a credible time path for the retreat of the direct control role of the state and the emergence of genuine, more accountable forms of regulation ?

In the next section we discuss the open agenda for regulatory governance.

## **SECTION III**

### **Regulatory capture**

Privatization outcomes are heavily affected by the institutional setting in which divestiture takes place. In countries where public regulation cannot control private activity, the speed of privatization should be aligned with the progressive strengthening of institutional foundations [Nellis (2003)]. Privatization can lead to increased efficiency and improved welfare only in settings with enough capacity to ensure appropriate protection of property rights, contract enforcement, control of market abuse, fair regulation and open entry, and commercial dispute settlement based on law, not payments.

At the same time, there are enough cases of poor performance of privatization in some contexts to alert us to some objective limits in private control, primarily due to regulatory inefficiency or outright capture. When the transfer of critical assets to private ownership cannot be managed safely (in the sense of avoiding losing control of the sale and the regulatory process), public control can have a temporary role, while some process of institution-building takes place. Yet to be feasible, the structure and role of this residual ownership form needs to be designed from the begin for this temporary purpose, however long it may take. The suggestion is that without an explicit commitment by the state to release control under some conditions, the process of institution building may not even start.

However, there are countries and circumstances in which there exists a lack of essential institutions to support or regulate private activities such that indeed rapid privatization may lead to an unacceptable loss of control over the economic system. In institutional contexts where there is a danger of significant loss of public control over safety due to privatization, such as in health care or basic infrastructure, outright

privatization is not desirable. In such cases, state control is a necessary, if perhaps temporary, intermediate step to support institution building. When privatization cannot escape capture, it may weaken corporate governance (weak regulatory, bankruptcy and take-over procedures, corrupt legal enforcement) and thus lead to a loss of ultimate control over the process and thus its goals. Hence some caution in the speed of privatization is called for. Partial, temporary state ownership may buy some time needed to establish the needed institutional and regulatory frameworks [Nellis (2003)].<sup>19</sup> The consequences of the failure to build up such institutions are disappointing economic and welfare effects, and a political backlash which sets the state back in control and blocks further institutional development. Yet the state has to be further removed from direct involvement in the economy, in order to progressively create some scope for allocating residual regulatory and enforcement rights in new institutions. The emphasis should be towards creating increasingly professionalized and autonomous regulatory institutions which draw their legitimacy and the right to gain further autonomy from a direct, i.e. nonstate form of governance which involves consumers and citizens to a greater extent.

This points to a natural sequence of privatization and regulation. First, smaller firms, and generally firms in competitive sectors, can be sold quickly via a transparent, open auction system. Larger firms may be sold more gradually, depending on the need for both confidence building for investors (Perotti, 1994) and for regulatory development. Here the experience with the telecommunication industry points to the failure of the notion of natural monopoly, where the very act of privatising usually has ensured greater scope for entry and thus self discipline by the market. Finally, so called public service activities should be gradually made more autonomous, exposed to competition and introduced to subcontracting. A caveat in this evolution is the risk of demerging firm activities to the point where different activities (such as rail maintenance and train services) may fail to be properly coordinated, or responsibility attributable.

Recent evidence (Acemoglu and Johnson 2003, Djankov et al. 2002) suggests that the most important institutions are those who provide restraints on the executive and

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<sup>19</sup> For a related discussion on the role of institutions see Shirley and Walsh (2000).

reinforce its accountability, i.e. which limit abuse of power, over those which regulate relationships among individuals. The reason may be that power restraining institutions also correct political incentives to favor strong private interests, for instance to control market power, and thus undermine a level playing field and the process of entry by new producers.<sup>20</sup>

State capture by special interests seriously weakens the credibility of enforcement. While corruption accompanied transition in all countries, its extent in the FSU (Former Soviet Union) led many authors to describe it as state capture, where the corrupting agents hold more power than the corrupted officials. There is evidence that while connected firms benefit, on average, firms grow less than in less captured economies (Hellmann, Jones and Kaufmann, 2000). In Russia, Yeltsin, who had needed the support of special interests to remain in power, and allowed them a free reign in plundering state assets and escaping obligations. The private capture of the privatization process further weakened the ability of the government to control the excesses of the most powerful private owners.

A way to summarize the case for a further retreat of state ownership even in countries with poor institutions comes from Djankov et al (2002). They argue that the more civic capital a country has, the more it is able to achieve cooperation among its members without coercion. Civic capital, fixed in the short run, is determined by culture, factor endowments, and history.<sup>21</sup> The less civic capital a country has, the less it can 'buy' order with extra regulation. Thus less developed countries can achieve less with regulation. Deregulation of competitive markets in less developed countries should then count as a high priority. The presence of relative high barriers to entry in such countries suggests that regulation is often captured and thus tends to hinder growth. But just as

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<sup>20</sup> Perotti and Volpin (2003) suggests that in a context of poor political accountability, established interests can lobby successfully to adapt regulation and even selective enforcement in their favor, blocking entry by new firms. Thus institutions reinforcing political and regulatory accountability are a preliminary step to ensure also proper enforcement of relationships among individuals.

<sup>21</sup> An interesting argument is put forward by Acemoglu et al(2002) that early settlers mortality in colonial times affected whether the laws of the colony were set to facilitate extracting and plundering resources and thus aimed at social control or to protect the rights of settlers from the mother country. For related evidence, see Engerman and Sokoloff (2000).

barriers to entry must be reduced, the urgency to amend the regulatory institutions increases. We claim that this requires a deliberate policy, towards greater scrutiny and accountability via a more directly elected form of regulatory governance.

### **Regulatory governance**

We have drawn so far a basic conclusion. Both private agents and public sector face commitment problems because of incomplete information, incomplete contracts and incomplete legislation. Since governments are sovereign institutions, they have more difficulty in committing to specific decision criteria than the private sector. They should ideally be constrained by private ownership, and the private sector should be constrained by regulation. Thus the critical question shifts to the governance of the regulatory institutions.

Regulatory authorities have grown throughout the developed and developing world as a result of privatization, and exhibit various degrees of autonomy.<sup>22</sup> We will make the point here that whatever the record, the separation of tasks tends to generate additional open scrutiny and necessarily improves the governance of the regulatory process, at least as long as it is not captured.<sup>23</sup>

In the language of Pistor and Xu (2002), laws and regulations are necessarily incomplete, just as contracts are. By default, residual rights to regulate belong to the state. Yet the authority to adjust enforcement under unspecified contingencies could be granted to semiautonomous judiciary or regulatory authorities. The role of regulatory agencies is more proactive than courts, which may respond only after damaged parties bring legal action and may not intervene preventively.

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<sup>22</sup> Many frequently levied critics to the effectiveness of regulators has to recognize that inefficiency in the past was less observable as it was buried inside a ministry or a public budget.

<sup>23</sup> Regulatory capture can occur either because of uncontrolled abuse by politicians, or because beneficiaries are dispersed while producers have concentrated benefits.

Provided such institutions operate under a framework in which they can avoid being captured, granting them progressively increasing residual enforcement rights has several advantages over the assertion of direct state control.

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

The ability of ensuring that regulators act in an independent and accountable fashion towards their stated goals can be reinforced by a novel approach to their governance. Their mandate should be temporary and subject to public review: their governance should include representatives of consumers and other nongovernmental organization. There are traditional forms of institutional governance, such as in mutual banks or administrations of public infrastructure, in which there are elected representatives of users. This concept should be broadened and further experimented in other contexts as well.

An important distinction needs to be made between NGOs and grassroots organizations. Especially in developing countries, grassroots organizations are arrangements around specific shared interest by the population (say small farmers or craft makers, or neighbourhood organizations). They are usually detached from the political system and relatively communal in nature. In contrast, NGOs are often foreign-inspired, staffed with more educated individuals, often driven by some strong vision. They are better politically connected, or at the very least have some access to foreigners in terms of either funding or visibility. Clearly, the two types of organization are complementary. It could be particularly interesting to create stronger links between the ability of NGOs to mobilize external resources or broader attention and the ability of grassroots organization

to mobilize support or public opinion. They should therefore have distinct roles in regulatory governance, yet they may also become encouraged to cooperate more to ensure that fundamental needs may rise to the attention of the regulatory system.

In conclusion, we argue that the governance process of regulators should take a more democratic, directly elected turn.<sup>1</sup> The logic of the argument is not democratization per se; there are agency and common good problems to this solution as well as to others. The logic of this proposal reflects the sensible economic principle that those who have the greatest benefit from proper regulations should be at least in part entrusted with its governance (Bestley, 2000). Thus the composition of a regulatory board may include representatives from different constituencies and nongovernmental organizations, elected on a rotational basis from broad lists.<sup>24</sup> The governance assignments of individual organizations may be made temporary, and extensions and rotation may be made subject to public, rather than political, approval. Importantly, the regulators should be subject to various forms of explicit accountability by the establishment of specific quantifiable or verifiable goals, and they would need to report on an annual basis as to their achievements. A task of the external appointees would be then to report publicly on their view on the regulatory effort, and contribute to adjust the statement of regulatory intents and their priorities by increasing public scrutiny.

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<sup>24</sup> A strong advantage of nongovernmental organizations, when allowed to express freely, is that they are harder to capture. On the other hand, Besley (2000) cautions against excessive enthusiasm for NGOs, particularly in contexts in which there is too little choice among them, and argues for increased transparency in their budgets and activities.

## **Conclusions**

The issue of public versus private governance in circumstances of market failure hinges on the relative ability to commit to a fair and efficient allocation. We have argued that the state has on average a greater difficulty to commit, due to its status. State control should remain an extreme solution, not advisable except in circumstances when privatization leads to uncertainty over the allocation of ultimate control. This is evident in the case of executive powers and public security, as in the case of the army, the police or the prisons.

In countries where private commitment is hindered by poor legal enforcement, a case can be made for some form of state control. Yet because such environments are also commonly associated with corrupt politicians and unconstrained abuse of power, the public commitment problem is here even more serious. The evidence in the recent literature clearly points to institutional development as a preconditions for the functioning of both private and public policy (see Acemoglu et al (2003) on macroeconomic instability in poor institutional environments, which produce worse outcomes even after controlling for policy choices.

The conclusion is that in such environments there is too little institutional capacity for proper state-controlled regulation, and thus the balance should be for less direct state control.

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

In conclusion, a residual degree of state control, rather outright ownership, may have a role when proper institutional mechanisms are not (yet) in place. Yet this role

must be progressively reduced by the creation of intermediate, focused regulatory institutions which may offer some weakening of the political grip on decision making. Forcing separation of enterprises from ministries, ensuring their incorporation ownership, establishing independent regulators and ensure their progressive autonomy in residual regulatory rights, moving to temporary mixed may create a dynamic decrease in the residual role of the state via greater exposure to market discipline and incentives, while increasing accountability.<sup>25</sup>

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<sup>25</sup> Kikeri et al (1992) review some lessons form privatization experience , and emphasize how regulation is critical to the success of privatization. Transparency via competitive bidding procedures, coupled with objective selection criteria for bids, is critical for the economic and political success of the process. In the end, these lessons reinforce the arguments for shifting attention to regulatory governance.

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## **APPENDIX**

### **A NOTE ON THE HISTORY OF STATE OWNERSHIP IN AFRICA AND LATIN AMERICA**

#### **Latin America**

In Brazil and Mexico the state has been at the center of the post-war political economy (Schneider 1988). Nationalist, developmentalist leaders in both countries created large state firms in 1930-1940 in heavy investment, high control areas such as in energy, infrastructure, finance and transportation sectors. After the war, both governments pursued their strategy of state-led industrialization to substitute imports further. State intervention in both countries was based on developmental motives. State enterprises fuelled growth and industrialization through investment: the largest Mexican firms accounted for 24% of total investment in 1978, their Brazilian counterparts were responsible for 20% in 1975. In the early eighties, the six largest state firms in Brazil accounted for 81% of all enterprise sales, 69% of spending, 80% of investment and virtually all state-enterprise debt.

Over the decades, the government's role expanded throughout the system which in effect created a bureaucratic political economy; an economy characterized by political capitalism (profits accumulation is dependent on policy, not markets), a development state (the state should assure growth and industrialization), and representation through bureaucracy (the system leads to weak legislatures and judiciaries, implying that the allocative center was with the social elite in the bureaucracy). This state control has been used for blatant political purposes.<sup>26</sup> The primary push for privatization in Brazil has come from mid-level officials trying to rationalize the developmental state. Control over the state sector has also been a critical element for maintaining power in Venezuela and Mexico.

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<sup>26</sup> In Brazil, for example, Sarney used the state to secure his fifth year in office by appointing supporters throughout the system. This has led to resignations of managers in state firms (with little effect).

In conclusion, in Latin America the state sector has often created large rents for politically favored individuals and constituencies. This power block has for a long time worked against the economic integration of these countries in an attempt to defend these rents.

The process of dismantling the excesses of state control has taken a long time. Before the start of privatization programs in 1983, the Mexican state was involved in nearly every sector of economic activity, with the stated intent to improve infrastructure, realize import substitution, regional development, and job creation. Mexico, a trailblazer in the region, started to reduce the number of smaller state firms under Miguel de la Madrid, and later moved to sell larger firms. However, the structure of privatization sales was designed under the influence of strong links between powerful private interests and politicians. The result were highly leveraged purchases at low prices, and an extraordinary degree of fraud and self-lending (de Silanes et al) which led to a devastating banking crisis. Once again, private capture of the process of privatization may lead to worse outcomes than state ownership.

McKenzie and Mookherjee (2003) provide an excellent overview of the impact of privatization in Latin America. Macedo (2000) gives a quantitative overview of the distribution of assets and income in Brazil.

## **Africa**

The decolonization period in Africa produced a very high degree of state ownership in large enterprises. Generally, very small groups have benefited from the experience, and most of the social consequences have been generally damaging in the long run. Yet most African countries have accepted privatization only reluctantly, often only in response to pressure by the IMF or the World Bank.

On average, African states have privatized a smaller percentage of their SOEs than other regions like Latin America. The main reason, besides lack of expertise and

resources, is political opposition to privatization by labor unions and some domestic producers (often with cosy relationships with SOEs).<sup>27</sup>

In general, African privatizations have been reasonable successful and often resulted in improved profitability [Boubakri and Cosset (1999)]. However, the distribution of gains has been extremely unequal, and little attention has been given to control market abuse.

Boubakri and Cosset (1999) and Nellis (2003) give a excellent overview of the impact from privatization in Africa. Mytelka (1989) gives an overview on African industrialization, its failures, and the role of the state. For specific analysis of state ownership in Africa, see Killick (1978) and Appiah-Kubi (2001).

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<sup>27</sup> Sader (1995) has shown that privatization is a driving force for foreign direct investment (FDI), which can contribute to technological transfers and greater capital availability.