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Introduction

Takatoshi Ito and Anne O. Krueger

After several decades in which public-sector enterprises (PSEs) played large and often increasing roles in national economies in most countries in the world, the past two decades have seen a reversal. In industrial countries, privatization efforts started in the late 1970s and 1980s as concerns with the efficiency and cost-effectiveness of state-owned enterprises mounted. During that same period, it was becoming increasingly evident that PSEs in many developing countries were not fulfilling their intended roles—they were high-cost monopolies, often greatly overstaffed as politicians used them to provide employment for friends and relatives. Privatization began tentatively in a few countries, and then picked up momentum in both the pioneers and others. The original motives were buttressed by the need for revenues from privatization and from elimination of PSE losses to reduce fiscal deficits, as the costs of inflation became increasingly evident. Then, in the early 1990s, the collapse of the command economies of the former Soviet Union and of Eastern Europe resulted in strong pressures for rapid privatization in those countries. By the late 1990s, increased appreciation of the importance of the financial sector's efficient operation led to intensified efforts for privatization of financial institutions, as well.

Privatization did not always proceed smoothly, however. There were questions associated with methods of privatization, as well as with the structuring of the environment for operation of newly privatized firms. With regard to the former, governments found themselves under attack because public enterprises had been "given away" or sold too cheaply, or

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because ownership had been granted to cronies rather than to the most deserving. When, in Eastern European countries, citizens were given shares in individual enterprises, concerns arose that there would be no effective ownership control over management; when enterprises were instead sold to a few large buyers (especially if they were foreign), allegations of monopoly power were made. Questions also arose as to the desirable degree of restructuring of PSEs that should occur prior to privatization. Controversies also surrounded efforts to shed excess manpower, either while enterprises were still in the public sector or when new owners attempted to reduce costs.

Moreover, it became clear that it was not enough to transfer ownership to the private sector, even if the problems enumerated above were satisfactorily addressed. Once firms were no longer publicly owned, key issues arose with respect to corporate control of management and the environment in which the newly privatized enterprises functioned. Some enterprises were privatized with owners who had little control over managements, which continued to run their firms in the same ways as before. Some privatized firms were natural monopolies, and where regulatory frameworks (or competition) were not provided, the new owners simply reaped monopoly profits (although there is evidence that many of these owners did reduce costs at least to a degree).

As if these problems were not enough, it quickly became evident that for markets to function well, an appropriate infrastructure is necessary. This infrastructure requires a legal framework in which corporate governance, a commercial code, and other rules of the game are elaborated and enforced. Corporate governance entails not only the relations of owners to managers, but the rights of minority shareholders, regulations governing accounting procedures and the provision of information to shareholders, and accountability of boards of directors. Commercial codes enforce contracts and enable transactions to take place over time. Bankruptcy laws provide creditor protection and enable preservation of value or orderly exit, whichever is appropriate.

Most of the lessons learned to date have come through experience. Privatizations deemed no more than partially successful have resulted in greater appreciation of the legal environment and infrastructure in which private enterprises have functioned in many market economies. Features—such as bankruptcy and minority shareholder rights—previously taken for granted have been better understood as analysts have examined the implications of their absence or malfunctioning. As experience with privatization has grown, so has appreciation and understanding of the issues involved in successful privatization. Successful outcomes depend not only (and perhaps least) on the successful sale of the company, but more importantly on the rights of owners, the legal framework in which corporate governance functions, and the ways in which incentives are provided for the privatized firms to respond as competitors rather than as monopolists.

In this volume, some of the main lessons from privatization in the East Asian region are brought together and analyzed. The first three papers provide overviews of key aspects of the process.

In chapter 1, Simon Johnson and Andrei Schleifer note that "[p]rivatized firms with weak corporate governance have repeatedly demonstrated weak performance and have frequently been 'tunneled' by their management. . . . The lesson from postcommunist countries is that effective investor protection needs to accompany privatization." They then proceed to analyze the appropriate forms of corporate governance, addressing in particular the question as to whether market participants can for themselves work out appropriate contracts for corporate governance (with the government relegated to the role of contract enforcement) or whether a more active governmental stance protecting shareholder rights is appropriate.

Johnson and Shleifer then review the growing body of empirical evidence that has emerged on this issue. They provide a concise overview of much of that empirical evidence, showing the ways in which economists have been able to provide answers to the basic question as to whether the legal framework matters. They conclude that "[t]he evidence that legal rules matter is overwhelming." While private contracts can to some degree compensate for the absence of an appropriate legal framework, Johnson and Shleifer show that the degree to which they can do so is far from adequate. When protection of shareholder rights is in itself weak, stronger investor protection in stock markets can partially compensate.

Chapter 2, by Philip L. Williams and Graeme Woodbridge, analyzes Australia's merger policy and the lessons it may provide for other countries. They focus on those instances in which there is a trade-off between efficiency and competition because of economies of scale. In Australia, there were a significant number of cases in which mergers would have resulted in greater efficiency, but would simultaneously have reduced competition. Williams and Woodbridge believe that appropriate merger policy must weigh the trade-offs between the benefits to society of lower costs and the associated costs of greater concentration of economic power. Moreover, there are benefits to speed in evaluating mergers, and the authorities must be able to form their judgments based on secret information. These requirements, in turn, render it difficult to achieve a transparent and fair process for evaluating mergers. The authors show how Australia's law governing mergers was insufficiently cognizant of these requirements, and how the process of approval therefore became informal and secretive in order to avoid the high costs of public knowledge of the relevant information, and suggest that a more transparent and fairer process could be devised that has legal standing.

In chapter 3, John McMillan provides a framework for evaluation of the use of markets to solve economic policy problems. His analysis focuses on what he regards as the "middle ground" between government ownership and purely private governance, which arises when government permits an activity to be conducted privately but maintains substantial control rights. To illustrate his points, McMillan uses four examples: emissions trading (for environmental protection); spectrum auctions (in which public policy designs the market); electricity regulation (where Californian efforts at deregulation were badly designed); and fisheries (where the government sets the quota to protect the "tragedy of the commons" and overfishing). McMillan argues that markets generate information, otherwise unavailable to governments, that can be used in the appropriate regulatory environment if governments use markets to induce the revelation of needed information. But, at the same time, markets cannot by themselves solve public policy problems, and regulation (and information) continues to be needed (as with the fisheries quota). McMillan concludes, after examining the four cases, that improper regulation can lead to results as bad as, or worse than, the market outcome. By the same token, however, appropriate regulation can in many instances achieve an outcome superior to that attainable in an unfettered private market.

These three papers provide an overview and framework of the theme and issues of the rest of the volume. They provide important theoretical and practical insights for individual cases and sectors in different countries. The rest of the volume consists of empirical investigations of particular industries in a particular country.

The next group of papers examines individual experiences in East Asian countries. In chapter 4, the first paper of this section, Il Chong Nam surveys Korea's policy toward privatizing the large PSEs. He shows that, until the 1990s, there was no effort to do so. Then, starting in 1994, a privatization movement developed, which culminated in a 1997 law to privatize large public-sector corporations. This was possible because of a change in the political regime at that time. Divestitures started after the passage of the 1997 law. Nam shows that the divestitures were not sufficiently extensive to prevent the government from intervening in the enterprises. He believes that limited success resulted from insufficient attention to competition policy, the regulatory framework, and industry structure. He also notes the linkages between treatment of the to-be-privatized PSEs and treatment of the *chaebol:* they were not initially permitted to bid to take ownership of any of the PSEs, but they are so important in the Korean economy that their absence was critical. Further progress in privatization almost certainly will entail an integration of competition policy, policy toward the *chaebol,* and divestiture, illustrating yet again the importance of the infrastructure and environment in which individual enterprises are privatized.

Korean corporate governance is the focus of Sung Wook Joh's chapter 5.

She analyzes the financial difficulties of Korean firms in the run-up to 1997, noting the incentives to borrow and the falling profitability of firms prior to the outset of the crisis. She then links the financial performance of different enterprises with the control and ownership rights prevailing before the crisis. She found that, controlling for other variables, firms with a high controlling-shareholder ownership had better profitability and financial performance than did those with much less concentrated financial interest. When the disparity between controlling and small shareholder interest was sufficiently large, however, controlling shareholders followed their own self-interest and "expropriated small shareholders." In her words, "Korean firms' low profits persisted because the corporate governance system did not induce firm management to maximize firm value." Joh believes that the absence of a credible exit threat, inadequate financial information (including the absence of financial institutions monitoring performance), the virtual absence of minority shareholder rights, and weak boards of directors all contributed to poor corporate performance, which in turn triggered the Korean financial crisis of 1997. She concludes that, in the aftermath of 1997, the Korean government has been altering incentives to align the interests of major shareholders more closely with those of maximizing the value of the firm.

Youngjae Lim, in chapter 6, argues that corporate governance fundamentally changed after the economic crisis of 1997 in Korea. Using a firm-level data set, he shows that after the crisis, the largest firms are leaving banks and switching their financing to capital markets, while the small and medium-sized firms are increasing their dependence on bank financing. A gap in corporate profits has widened after the crisis. Since banks are losing their best customers, the future profitability of the bank may be questioned. Also, changes in the corporate finance may affect corporate governance in the future, but it is too early to make definite statements on these points.

Chong-Hyun Nam was a conference participant and made excellent comments during the conference. Since Dr. Lim adopted most of the comments that were suggested by Dr. Nam, we did not include Dr. Nam's comments in this volume. This is a rare instance where a discussant is so perceptive that his comments are fully adopted and he becomes a "victim of his own success." We appreciate Dr. Nam for his appropriate and constructive suggestions for improving the paper.

In chapter 7, Chen Chien-Hsun and Shih Hui-Tzu examine the relationship between initial public offerings (IPOs) and corporate governance in China during the transition. Chen and Shih find that IPOs resulted in little, if any, change in the performance of companies having undergone IPOs in industries other than public utilities, transportation, and finance. They find a number of reasons for this. First of all, they note that companies planning to list an IPO may be tempted to inflate earnings or balance-sheet figures pre-IPO, thus leading to statistically poor performance after the IPO. But they also note that "there is too much insider trading, the responsibilities of the boards of directors are not sufficiently defined, there is too much administrative interference, too many problems of internal control, and so on." They conclude by noting that the quality of listed companies is a major factor in determining the health of capital markets in any country, and that measures that result in improvements in the quality of IPOs are therefore an important part of the development of China's capital markets.

Chapter 8, by David D. Li and Frances T. Lui, seeks to ascertain the determinants of the kinds of state economic enterprises in China that are privatized. They explore the incentives confronting the government and the workers that would lead them to decide to privatize. One hypothesis focuses on the desire, by the government, for greater economic efficiency. Another is the need to reduce the fiscal burden of individual enterprises when the subsidies from the government get too large.

The authors carry out a probit estimation to examine whether the conditions derived from their theoretical model indeed predict the probability of privatization or liquidation. Various factors that may contribute to the probability of privatization/liquidation are analyzed and interpreted. The authors find that their efficiency measures did not have a statistically significant impact on the decision. They interpret their results to mean that governments privatize state-owned enterprises (SOEs) in order to increase government revenue and reduce the size of subsidies. Governments are more reluctant to privatize when there is likely to be larger resulting unemployment or when the loss of political control will be more significant. The authors conclude that first-best (from the economist's viewpoint) privatizations may not be feasible, and that policymakers seeking to improve economic welfare may be well advised to seek second-best solutions that take government objectives into account, reducing the size of layoffs and generating large revenues.

In chapter 9, Tetsushi Sonobe and Keijiro Otsuka contrast the town and village enterprises (TVEs) and SOEs in China. They first note that until the early 1990s, the dominant move away from state ownership was through the establishment and growth of TVEs; it was only in the 1990s that privatization of SOEs began to take place. They hypothesized that (1) intervention in the management of TVEs by local governments became less productive in the 1990s because of the declining importance of SOEs for the operation of TVEs and (2) recent privatization improved the productive efficiency of TVEs without sacrificing marketing efficiency. They use a unique data set, with information on the garment and casting industries for the greater Yangtze region.

Using econometric methods and their rich data set, the authors obtained results that they interpret to relate primarily to the short-run effects of privatization. They conclude that privatization yielded positive significant effects on productivity in both industries. Privatization and its accompanying benefits accelerated in the mid-1990s, as the relative importance of SOEs declined and that of free market transactions increased. That, in turn, made interventions by local governments less productive. They believe that the greater competition resulting from privatization will continue to lead to productivity growth over the medium and longer terms.

Reform of the SOEs is one of the most important policy priorities. Yang Yao's chapter 10 investigates privatization in China. It shows that politicians' commitment to reform is important in improving economic performance in the private sector. The fewer the political rent-seeking activities, the better the private-sector performance. Privatization is viewed as the additional incentive to engage in reform. The case study of the Shunde region is presented to show how the reform was successfully implemented in the region. Government commitment was shown by the reforms in the government sector—consolidation of the government agencies and reduction in the number of government employees. The efficiency and transparency of the government led to better firm performance.

The next set of papers focuses on issues of sectoral privatization and regulation. The first, chapter 11 by Helen Owens, covers the behavior of the Australian railroad industry under various regimes. Alternative methods of dealing with railroads, as Owens notes, include downsizing by separation of activities, corporatization, privatization, and renting out the tracks to competitive service providers. Owens points out that no single method always works, and that each method has its drawbacks. There is no one right method for all time. In part, this is a consequence of the fact that railroads had a large element of natural monopoly (although that element has diminished in recent years), which means that whatever method is used, a simulation of competition must be achieved by some means. But there is also the consideration that railroads relieve some of the (untaxed) congestion from highways. To the extent that they do that, they are offsetting a negative externality. In addition, timetables must be coordinated (for safety reasons), and technological change (such as air freight) can change the environment.

Owens offers some tentative conclusions (at least for existing technology): If there is sufficient competition between transport modes and competition among railroads is possible, vertical separation may be appropriate. If, however, there is little possibility of competition among railroads, vertical integration makes more sense, accompanied by promotion of competition for the market. When there is market power in a network, vertical integration is also appropriate, but awarding contracts on the basis of the lowest rates and periodic recontracting can reduce monopoly rents. She concludes, however, that the situation must be judged on a case-by-case basis, and that there is no universal rule.

In chapter 12, Fumitoshi Mizutani and Kiyoshi Nakamura discuss the Japanese experience with railways. They start by providing background for the privatization decision, which was based on a desire to reduce both the government subsidies to railroads (which were one of the three largest in the 1980s) and the political constraints on railroad operations that contributed to operating deficits. Once privatized, the railroads improved their performance.

The paper examines the performance of national rail privatization in several dimensions. First, overall performance is examined. Performance improved after privatization. Second, the effect of horizontal separation is evaluated. The sizes of the divided companies are examined by comparing them to privately owned rail companies. Third, vertical integration was maintained in Japan, while separate infrastructure was created in the United Kingdom. The authors judge that the vertical integration is economically more efficient. Functional separation (freight is separated) also improves performance. Railroad privatization increases competition in the market and efficiencies of the privatized companies.

In chapter 13, Tsuruhiko Nambu analyzes developments in the Japanese telecommunications industry since 1985, when privatization and deregulation began. The author argues that privatization with incomplete deregulation has resulted in an unsatisfactory situation in Japan. In part, this is because the rate structure was left intact at the time of privatization: there was no attempt to permit competition in some parts of the system with access fees to the trunk lines, nor was there any rate rebalancing (as was undertaken in the United Kingdom). Only three long-distance carriers entered the market, and they earned high rates of return. However, one of those three has exited the industry, while a second is being acquired by Vodafone. Nambu argues that some of the additional reform measures, such as further dividing local companies into regionals, do not make sense, while some others, such as competition policy with wireline and wireless, may be beneficial for the economy.

The last two papers focus on the financial industry. Charles Calomiris and Joseph Mason, in chapter 14, consider the policy issues arising from distressed banks: should they be rescued? On what terms should resources be transferred to banks? What lessons can be drawn from the experiences in the past (in particular those in the United States in the 1930s) for Japan and other Asian countries? With respect to the first question, the authors regard bank finance as crucial for financial intermediation of funds from savers to investors, especially in countries without strong capital markets, such as in Asia, and conclude that public policy to intervene in the process of bank failures (or prevent them) is called for. However, the design of intervention is important in order not to give wrong incentives to banks. The bank supervision framework should encourage market discipline to reward value creation and prudent risk management. Although costs may be quite high, such as 20 percent of gross domestic product in recent Asian currency crisis countries, the bank should be helped. The authors observe that costs of bank rescues depend on the choice of which banks to rescue and the means by which rescue is effected. Not all banks may be rescued, and foreign banks may be encouraged to enter the market, although they are not perfect substitutes for domestic banks. The rescue efforts should be focused on relatively solvent banks and those with high franchise values. Costs of partial bailout should be considered. The rescue efforts should minimize moral hazard, and that would reduce costs substantially. For example, high-risk lending should not be allowed after infusion of government capital. The U.S. experience in the 1930s, especially the role of the Reconstruction Finance Corporation, is reviewed and contrasted to the Japanese experiences of government loans and preferred stock purchases in 1998 and 1999. The authors recommend combining subsidized preferred stock purchases with mandatory matching contributions of common stock, limits on bank dividend payments, and reforms of bank capital regulation to use market discipline.

The final paper, chapter 15, by Aaron Tornell, analyzes the role of bailout guarantees that accompany bank privatization and financial liberalization in many episodes over the past decade. He argues that where firms are constrained in bank credit, bailout guarantees can encourage banks to lend and enhance long-run growth, provided that they are accompanied by appropriate policies, such as undertaking bailouts only in cases of systemic crisis and establishing an efficient regulatory framework. The cost of pursuing higher long-run growth is an increased vulnerability to crises. However, the chance of an actual crisis should be small to avoid the unintended effect of reducing productive investment. The model analysis is accompanied by a case of policy dilemma caused by the Mexican banking crisis that followed the currency crisis of 1994–1995.