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# Privatization, financial development, property rights and growth

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ABSTRACT

This study analyzes how prevailing institutional arrangements i.e., property rights, contracting rights, political institutions, and corporate governance practices affect privatized firms' performance, capital markets development, and economic growth. Most of the studies surveyed show that privatization enhances privatized firms performance, efficiency, and profitability, which percolates to economic growth. Privatized firms performed better in countries with better regulatory and legal frameworks. Partial privatization may be beneficial in countries with weak institutions, namely, the French civil law countries. The stronger the economic and the governing institutions, the easier it is for privatized firms to thrive and contribute to economic growth. Overall, privatization allows firms to achieve improved efficiency while driving the development of the financial sector.

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## 1. Introduction

Privatization of state-owned enterprises (SOEs), a contentious issue of public policy debate, has long been topical in policymaking and academic arenas. The extant literature has credited the policy with effectively pushing inward the state's frontiers while revitalizing and transforming SOEs into driving forces for economic growth and development (Li et al., 2011; Schuster et al., 2013). Privatization has been an integral part of the international polity mix, and a plausible policy prescription for decades (Dahl and Lindblom, 1953; Harvey, 2005; Bjørnskov and Potrafke, 2011). In essence, it deals with diversionary and loss-making SOEs in ways that address many of the underlying issues related to their inefficiency and lack of profitability. Economists are split on whether the state should involve in the provision of goods and services, and when necessary, the limits of such an involvement. As the debate on the merits of state ownership unfolds, this study intends to review the privatization literature from different perspectives including institutions, property rights, growth, and financial development to update the reader on the existing arguments as well as the prevailing empirical evidences.

Legal institutions and level of financial development make privatization through conventional techniques a real challenge (Rapacki, 2001; Harvey, 2005). Political concerns threaten both the freedom of actions granted to the newly-privatized firms and efforts to expand privatization programs (Cragg and Dyck, 1999). As Lopez-de-Silanes (1997) and Borisova and Megginson (2011) advocate for quicker privatization, others find evidence that privatization is a difficult process consisting of staggered sales rather than wholesale of SOEs' assets or large-scale experiments of social engineering (Gupta, 2005; Fan et al., 2007; Bjørnskov and Potrafke, 2011); and one of the possible hindrances seems to be political and institutional realities (Boubakri et al., 2011; Dinç and Gupta, 2011).

Large amounts of research along with substantive surveys by Dombeger and Piggott (1986), Megginson and Netter (2001),

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Djankov and Murrell (2002), Clarke et al. (2005), Estrin et al. (2009), and Fan et al. (2011) have been produced on privatization, yet results regarding the relation between privatization and firms' performance and their efficiency do not lead to any definitive conclusion.[2] One of the lessons drawn from the existing literature is that privatization, in most cases, at varying degrees, does lead to better performance. Our conjecture is that privatized firms' performance and contribution to growth vary along institutional and property rights dimensions. Accordingly, this study focuses on the links between privatization and institutions to highlight some additional (specific) institutional features supporting privatized SOEs' revitalization upon market infused new energy. More specifically, the study centers on institutions, property and contracting rights protection frameworks and how they incubate investments and growth through SOEs privatization; and surveys, though to a lesser extent, the links between the financial sector development and privatization.

With so many developing countries harboring backward institutional infrastructures, and privatization being such a multifaceted issue, it is important to analyze the program along several dimensions. These include the extent to which private property rights and contracting rights are safeguarded and their impact on the ability of the newly-privatized firms to restructure in conformity with market principles for greater efficiency and growth. Although there is no one-size-fits-all on the ways to actually make privatization work, the evidence supporting the superior efficiency of the privatized firms, while compelling, has been divided. One important missing link seems to be countries' ways of doing business, or societal and institutional arrangements for raising large-scale finance (through SOEs privatization), and by extension, uncertainties surrounding financial contracts. Additional and contextual evidences, therefore, are needed before broader judgments can be envisioned.

Property and contracting rights are cross-cutting issues epitomizing a country's institutional fabric. Bortolotti and Faccio (2009) conclude that the degree to which governments actually reduce their influence on privatized firms depends on the respective country's legal and governmental systems. The extent to which governments relinquish control over the privatized firms may have broader impacts on the corporate governance regimes thrust upon the newly-privatized firms. Boubakri et al. (2011) assert that political institutions in place, namely, the political system and political constraints, are important determinants of residual state ownership in the newly-privatized firms. It is important to investigate the links between privatized firms' performance along the dimensions of property rights protection and institutional quality and the implications for economic growth. What is the role played by political, property and contracting rights institutions in privatized firms' performance? Would SOEs match private firms' performance under any market structure had governments not interfered with their operations?

These perspectives may add to our understanding of cross-national differences in performances between incumbent SOEs and the newly-privatized firms. To address these issues, this study assembles different bodies of literature, revolving around the institutions hypothesis, maintaining that differences in countries' economic performance (and by ricochet firms' performance) are caused by a society's structural makeup. Claessens and Laeven (2003) put forward that in markets with weak property rights laws, efficient asset allocation may be thwarted as returns on assets are not protected against competitors' unlawful behavior as well as against predatory states.

Since political firms are predestined for political uses and corporate governance is weak at these firms subject to political interference from politicians, special pressure or interest groups; at root, reducing the influence of the state on these firms through privatization may weaken paternalistic and corrupt practices by public officials, the need for extra-legal payments, and the venues for output and employment decisions supplanted by political rather than economic rationale. Privatization may not only be a remedy for loss-making firms, but also a policy allowing the state to refocus its energy to its core competencies; especially, in many developing countries with large public sector and pervasive corruption. In addition, government's partial ownership may serve as a tool to monitor managers of the newly-privatized firms in those countries where market corrections mechanisms are weak or nonexistent. With the government on the privatized firm's board, this may be a type of private–public partnership, serving as some sort of guarantee for stakeholders.

The next section begins by examining the topic of privatization in a more general sense. It addresses the question of why private ownership is expected to deliver its produce more efficiently than do SOEs. The third section addresses the theoretical underpinnings of ownership forms. It presents some arguments on property rights protection and institutional quality and their impacts on the privatized firms' performance. It further discusses some macro-effects of privatization. The fourth section inspects the links between privatization and financial sector development. The fifth section offers new perspectives on the issue of privatization; while the last section concludes with some policy suggestions.

## 2. Privatization: forms and trends

Privatization may take several forms depending upon a country's initial stage, public sentiments, leaders' ideology, depth of financial markets development, type and size of firms slated for privatization, market structures, and goals and objectives set by ruling elites. The many forms of privatization include divestment or the transfer of SOEs' assets to private sector operators, frequently achieved through assets sales or auctions, spin-offs, liquidations, and reinstatement of the formerly nationalized SOEs into the private domain in accordance to market rules and principles. Privatization can be achieved through delegation or transfer of management and control of an incumbent SOE to the private sector. The new management team, therefore, is subject to market guidelines allowing it to adopt incentive structures and investment priorities that align with the firm's objective function. It may also be achieved through shifting or via tender, a set of practices whereby the public sector induces private firms to expand into some activities through outsourcing or contracting out key production functions heretofore performed by SOEs.

Among the most popular forms are shares issue privatizations (SIPs), voucher privatization, employee buy-outs, corporatization, and private–public partnerships. Regardless the form retained to implement the policy, it culminates in an expansion of the share of the private sector in the creation of economic value added resulting from managing productive assets in an economy. In the broader sense, privatization is a characteristic of an economy where the number of private firms and the share of the private sector to GDP tend to rise; while the number of SOEs and the share of the public sector in GDP decline as new policies to incubate investments and sustain the growth in private ventures take shape.[3] Several theorists[4] consent that the state should look to the private sector to undertake the role of providing goods and services that

[2] See also Cavaliere and Scabrosetti (2008).

[3] See Bennett (2001) for a detailed discussion on measurement of privatization and related issues.

[4] These include Adam Smith and Milton Friedman.

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