Journal of Corporate Finance xxx (2014) xxx–xxx

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Growth and growth obstacles in transition economies: Privatized versus *de novo* private firms☆

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ARTICLE INFO

Article history:
Received 16 July 2013
Received in revised form 24 July 2014
Accepted 27 July 2014
Available online xxxx

JEL classification:
G32
G38
L33

Keywords:
Privatization
Firm performance
Growth obstacle
Transition economy
World Bank Enterprise Survey

ABSTRACT

In this study, we employ the *World Bank Enterprise Survey (WBES)* data collected in 2002, 2005, and 2009 for 21499 firms from 27 Eastern European and Central Asian countries to examine firm-level growth constraints faced by privatized firms versus those faced by the originally (*de novo*) private firms. We find that the *de novo* firms experience significantly higher financial, corruption, and legal obstacles than the privatized firms. We further document that, even though faced with more obstacles in the business environment, the *de novo* firms outperform the privatized firms. One explanation is that the profit motive of the *de novo* firms is organic, whereas the profit motive of the privatized firms is acquired. The organic profit motive may be powerful enough for the *de novo* firms to overcome more difficulties in the business environment and excel. Our study is the first in the privatization literature to go beyond performance comparisons and examine firm-level growth constraints.

1. Introduction

The last few decades have witnessed a significant global shift away from state socialism towards entrepreneurial capitalism that has led to a major change in the structure of corporate ownership around the world. One of the most noticeable aspects of this trend has been the enthusiasm with which governments of all political persuasions have sold their state-owned enterprises (SOEs) to private investors (Megginson and Netter, 2001). An important reason for this trend is that governments have bought into the belief that private ownership and market forces can significantly improve the poor performance of the SOEs. Eastern European and Central Asian (ECA hereafter) governments were among the most enthusiastic in privatizing their SOEs in the 1990s and early 2000s (Estrin et al., 2009). More than a decade has passed since the conclusions of the major privatization programs in these transition economies. How do the privatized firms stack up against the originally private (*de novo*) firms? We study this question in our paper.

☆ We thank participants in the 2013 privatization conference on "Contracting Issues at the Intersection of the Public and Private Sectors" at Wake Forest University, and an anonymous referee for very helpful comments.
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http://dx.doi.org/10.1016/j.jcorpfin.2014.07.008
0929-1199/

Transition economies are commonly referred to the economies in Central and Eastern Europe (CEE) and in the Commonwealth of Independent States (CIS) that formed most of the former Soviet Union. Privatization programs in transition economies are quite different than those in non-transition economies. The most important difference may be that transition economies did not merely privatize their SOEs in order to improve efficiency. Like reforms in the political, financial, and legal systems, privatization was an important and integral component of the overall reform that helped transform the economic system and society at large. The outcome of these privatization programs is a function of the forces in the larger institutional, political, and business environment. Therefore, it is insightful to examine how these forces affect enterprises. In this study, we examine the financial, corruption, and legal obstacles faced by privatized firms versus those faced by the *de novo* firms. Privatized firms and the *de novo* firms are very different in one fundamental way. The profit motive of the *de novo* firms is organic in that they were set up to make profit from the very beginning, whereas the profit motive of the privatized firms is acquired in that their original motive likely includes both economic and social (employment) objectives. This distinction is important because privatized firms face a learning curve pursuing their newly acquired profit mandate. The learning curve likely includes restructuring management and personnel, capital structure, product lines, and so on. To the best of our knowledge, this paper is the first in the privatization literature that compares the firm-level business constraints faced by privatized versus those faced by the *de novo* private firms.

We further examine the relative performance between the privatized firms and the *de novo* firms, motivated by the current state of the literature on privatization in transition economies. Estrin et al. (2009) survey a large number of studies related to the effects of privatization and ownership in transition economies. They find a large variation of privatization outcomes, ranging from no systemically significant effect of privatization on performance (Bevan et al., 1999), to mostly positive performance improvement (Megginson and Netter, 2001), to strong evidence of positive effect of privatization on performance (Djankov and Murrell, 2002; Shirley and Walsh, 2000). Estrin et al. (2009) attribute this variation in the interpretations of privatization outcomes to several reasons. First, early studies had access only to limited firm-level performance and ownership data. Many of the early studies relied on performance data immediately before and after privatization. Estrin et al. (2009) argue that the effects of privatization should take longer to manifest themselves. Second, early studies used small and often unrepresentative samples of firms and ownership structure was difficult to identify because privatization was still ongoing. In addition, the cross-countries studies combined different accounting standards and employed accounting ratios as performance measures. Third, many of the early studies did not control for the selection/endogeneity problem associated with government's non-random choice of firms to privatize.

Our study is able to overcome some of the aforementioned limitations in the literature. First, we employ a large-scale, unique dataset, the *World Bank Enterprise Survey (WBES)* data collected in 2002, 2005, and 2009 for all 27 countries in CEE and CIS. The WBES refers to this group of countries Eastern Europe and Central Asia (ECA). Second, the WBES-ECA database allows us to clearly identify the origins of ownership types of the surveyed firms. Specifically, the dataset contains 17111 originally private (*de novo*) firms, 3895 fully privatized firms (0% residual state ownership), and 493 partially privatized firm (>0% residual state ownership).[4] Third, we employ sales growth, employment growth, and labor productivity as performance measures. These measures are calculated with only two inputs, sales revenues and the numbers of full time employees, and therefore, are less likely to be distorted by different accounting standards across countries. Furthermore, few studies in the extant privatization literature examine sales growth and employment growth of the privatized firms. Sales growth and employment growth are indicators of a firm's long term viability and should receive more attention from scholars and policymakers. Finally, it has been more than a decade since the conclusions of the major privatization programs in the ECA countries. This fact indicates that if privatization has an effect on performance, enough time may have passed for that effect to manifest itself. This fact also suggests that the endogeneity problem arisen from reverse causality is less of a concern in the current study. The ECA governments have completed their major privatization programs more than a decade ago. There is little evidence that the privatized firms are re-nationalized at all, much less based on good or poor performance. However, we conduct robustness check for possible endogeneity problems arisen from government's non-random choice of firms to privatize.

Our empirical results show that privatized firms experience significantly lower financial, corruption, and legal obstacles than the *de novo* private firms. The results are robust after controlling for relevant firm characteristics, country-level governance and macroeconomic variables, industry effects, year effects, and endogeneity check. Our empirical results further show that, even though the *de novo* firms face more difficulties in the institutional and business environment, they outperform the privatized firms in terms of growth and labor productivity. The results are robust after controlling for firm-level growth obstacles, relevant firm characteristics, industry effects, year effects, country fixed effects, and endogeneity check.

The paper is organized as follows. Section 2 reviews relevant literature and develops the hypotheses, while Section 3 describes data and summary statistics. Section 4 discusses the methodologies and presents the empirical results. Section 5 presents the results for endogeneity tests while Section 6 concludes the study.

2. Literature review and hypothesis development

In this section, we first review relevant studies concerning the relation between ownership structure and firm-level growth constraints. We then review the extant literature on the effects of privatization and ownership on firm performance.

[4] The WBES-ECA database also contains some not-yet privatized state-owned enterprises (SOEs). Due to the relatively small number of SOE observations and the focus of this paper, we do not include SOEs in our analysis.

Please cite this article as: D'Souza, J., et al., Growth and growth obstacles in transition economies: Privatized versus *de novo* private firms, J. Corp. Finance (2014), http://dx.doi.org/10.1016/j.jcorpfin.2014.07.008