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The political economy of residual state ownership in privatized firms: Evidence from emerging markets

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ABSTRACT

We investigate the political determinants of residual state ownership for a unique database of 221 privatized firms operating in 27 emerging countries over the 1980 to 2001 period. After controlling for firm-level and other country-level characteristics, we find that the political institutions in place, namely, the political system and political constraints, are important determinants of residual state ownership in newly privatized firms. Unlike previous evidence that political ideology is an important determinant of privatization policies in developed countries, we find that right- or left-oriented governments do not behave differently in developing countries. These results confirm that privatization is politically constrained by dynamics that differ between countries.

1. Introduction

Privatization can be defined as the deliberate sale by a government of state-owned enterprises (SOEs hereafter) or assets to private economic agents. This shift of ownership — and control — to private owners creates a change in the prevailing incentive structures, and puts greater emphasis on profits and efficiency (Boycko et al., 1996; Shleifer and Vishny, 1997). The literature provides strong evidence on the dividends of privatization and the benefits derived from private ownership as compared to government ownership (e.g., Megginson et al., 1994; Boubakri and Cosset, 1998; Boubakri et al., 2005b,c; D'Souza et al., 2005).[1] The evidence also suggests that performance is negatively related to the government's continued role in the firms. For example, in their research on a set of emerging markets, Boubakri and Cosset (1998) and Boubakri et al. (2005c) find that there is greater improvement in performance after privatization, which is more pronounced when the government relinquishes its control rights. These conclusions are echoed by Chhibber and Majumdar (1999), who find that privately owned firms in India are more efficient than those under mixed ownership or those run as SOEs. Shleifer and Vishny (1994) conjecture that when politicians maintain control over firms, privatizing cash flow rights will only reduce efficiency and increase corruption. According to this argument, to ensure successful privatization, the *immediate* transfer of control rights should be of primary importance (Boycko et al., 1996).[2]

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[1] Please refer to Megginson and Netter (2001) and Megginson and Sutter (2006) for an extensive review of the literature.

[2] These ideas are largely echoed in the debate on transition, where the relative benefits of a big bang approach compared to more gradual, sequenced reforms towards a market-oriented economy have generated wide interest among academics (see, for instance, Dewatripont and Roland, 1995; Roland, 2000; among others). The literature on privatization in transition economies is well summarized by Djankov and Murrell (2002) and Svejnar (2002). Note that we do not include firms from ex-communist countries in our study, as privatization in these countries is mainly conducted through vouchers distributed to citizens for free or at discounted prices, and not through typical methods such as asset sales or share issues.

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In practice, however, privatization does not always seem to follow this idealized model, especially in developing (non-transition) economies. In an evaluation of the privatization experience of developing countries over the 1988 to 2005 period, Boubakri et al. (2008a) show that instead of immediately divesting all of their ownership, most governments divest only partially over time. Boubakri et al. (2005b) provide further evidence on this phenomenon in a study of the evolution of post-privatization ownership structure in a multinational sample of 209 firms, mostly from emerging markets. They report that while privatization does lead to a drastic change in the ownership structure of SOEs, the transfer of ownership is mainly conducted through partial, staggered sales. Consistent evidence is also found by Gupta (2005), who shows that in India most privatization transactions are partial sales that leave the government in control, and by Fan et al. (2007), who show that in China the government is prohibited from selling its controlling stake in SOEs, which are thus privatized gradually by selling shares to minority investors.[3]

A possible rationale for continued government influence following privatization is provided by the theoretical model of Perotti (1995), who argues that partial privatization can signal the government's commitment to market-oriented policies. By relinquishing their control rights, governments signal that privatization is credible and implies no policy risk (i.e., risk of interference in the operations of newly privatized firms — NPFs hereafter — either through regulation or renationalization). By retaining residual ownership, governments thus signal their willingness to share in any remaining policy risk. As a result, and according to Perotti's (1995) model, partial privatization is a political choice that depends on the characteristics of the government in place, that is, on political institutions. Based on this model, Biais and Perotti (2002) show that right-wing governments, whose objective is to ensure their re-election, signal their commitment to the median voter through partial privatization and underpricing. Similarly, Jones et al. (1999) show that the terms of share issue privatizations — allocation and pricing — are structured to achieve political and economic objectives.

The purpose of this study is to determine how political institutions influence post-privatization control structure in a large set of emerging markets. Our analysis consists of two parts. First, using hand-collected firm-level data, we examine the residual control of privatizing governments using four measures of control: direct ownership, ultimate ownership, golden shares, and political connection. To our knowledge, this is the first study to document, using firm-level data, residual state control in emerging economies along these various dimensions. We find that residual state ownership over a window of up to six years following privatization shows a significant decline. However, the speed with which governments relinquish control appears to differ across industries and regions, and the state remains the controlling owner (holds more than 50% of the shares) in 46% of our sample firms. We further find that the method of privatization is correlated with residual state ownership; for instance, share issues on the stock market are associated with more gradual divestitures. In addition, governments tend to retain indirect control over NPFs through political connections (30.3% of our sample firms), and less frequently through golden shares (7.3% in our sample firms), which contrasts with Bortolotti and Faccio (2009), who document that 62.5% of a sample of OECD firms have golden shares (in 1996).

The second part of our analysis focuses on the impact of political governance on post-privatization control structure. More specifically, we assess how political constraints and institutions influence the government's residual ownership in the six years following privatization. Motivated by prior research, we conjecture that as a redistributive policy, privatization is politically costly and hence is necessarily constrained by the strength of checks and balances, by government ideology, and by the political system in place. Our multivariate analysis, which controls for other potential factors influencing privatization design and corporate ownership structure, shows that the decline in state ownership is indeed associated with a country's political environment. For instance, residual state ownership is higher in parliamentary systems and under regimes with greater constraints on the executive (checks). Contrary to what is documented for OECD samples, however, the ideology of the executive does not appear to affect residual ownership. These results are robust to several additional tests, and taken together suggest that it is important to control for a country's political environment and legal infrastructure when assessing the corporate governance of NPFs.

Our paper makes two primary contributions to the literature. *First*, our study extends prior work on the political determinants of privatization. Previous studies in this line of the literature focus largely on the country-level design of the privatization process.[4] For instance, Bortolotti and Pinotti (2008) conduct a country-level investigation of the determinants of privatization for 21 advanced OECD economies, and show that the likelihood and extent of privatization are strongly positively associated with majority-rule political systems. Bortolotti and Faccio (2009) provide related evidence on the determinants of the control structure of OECD-country NPFs for the period 1996 to 2000. However, by limiting attention to advanced economies, these papers' results may not generalize to emerging markets, where the public sector is relatively larger, where political institutions tend to exhibit less accountability, and where executives are less constrained and thus enjoy more latitude in decision making (Bortolotti et al., 2004; Klapper and Love, 2004). Earlier studies by Bortolotti et al. (2001, 2004) consider both developed and developing countries over the period from 1977 to the mid-1990s and, using *country-level* data, examine the determinants of the decision to privatize, the method of privatization, revenues from divestiture, and the ownership share sold over the sample period. Yet while Bortolotti et al.'s (2001, 2004) samples

[3] Extant literature on the impact of government residual ownership on firm performance is mixed. For instance, while Gupta (2005) shows that the partial privatizations in India did observe improved performance despite post-privatization government control, Fan et al. (2007) show that continued government influence through political connections in China's partial privatizations is detrimental to performance. The authors conclude that: "…emerging economies… can learn from the experience of China's partial privatization that a government's reluctance to relinquish (or its desire to retain) even only a subset of its property rights with regard to its enterprises can have significantly negative consequences on corporate governance and firm performance" Fan et al. (2007: p.353). Evidence on newly privatized banks in developing countries (Boubakri et al., 2005a; Otchere, 2005) indicates that privatization yields marginal improvements in post-privatization operating performance, which the authors attribute to continued government ownership.

[4] We are aware of two single-country studies on the subject. Clarke and Cull (2002) examine the determinants of the decision to privatize state-owned banks in Argentina, and Dinc and Gupta (forthcoming) investigate the role of elections in privatization design in India. Additional related papers include Dastidar et al. (2007) on policy reversals in India, Sapienza (2004) on the banking sector in Italy and Beck et al. (2005) on the banking sector in Brazil.