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Endogenous asset ownership structures in deregulated markets

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Abstract

This paper determines the equilibrium ownership structure in an emerging market deregulated by a joint privatization and investment liberalization. It is shown that bidding competition in the privatization stage is not sufficient for reaching an efficient equilibrium market structure. Competition in the ensuing entry stage is also required. Otherwise, one firm can induce another to take the role of the weak firm in the subsequent product market competition, by making concessions in the bidding in the privatization auction. It is also shown that Employment Guarantees may "help" the buyer of the privatized firm "abstain" from investing and thus create a less competitive market structure.

JEL classification: D44; F23; L1; L4

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1. Introduction

During the last decades, we have witnessed large privatization and deregulation programs all over the world.[1] These programs have been carried out in many

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[1]Privatization and deregulation activities are driven by factors such as a general trend of reducing the state in the economy, budgetary constraints, a need for attracting investments and a combination of technological change, liberalization and globalization of product and financial markets (OECD, 2000).

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different sectors of the economy, including the manufacturing sector, utility and communication services and the financial sector.[2] An important ingredient in many of these programs has been the use of auctions to allocate productive assets to the most efficient owner, thereby contributing to the creation of efficient market structures. However, there is a fear that many of these privatization and deregulation programs have not led to a fast creation of efficient market structures. For instance, while recent empirical evidence shows the long-run impact of privatization on firms' productivity in transition countries to mainly have been positive, it has also been acknowledged that the positive impact has taken time[3] and that ownership identity is of importance.[4] For instance, new investments in and radical reorganizations of product lines and processes were—at least in the early stages—only observed in foreign-owned enterprises.[5]

In this paper, we argue that the obstacle to the creation of efficient market structures is consistent with an inefficiency in asset ownership allocation, depending on a non-obvious weakness in privatization design. More specifically, we show that if privatization takes place through an auction,[6] an inefficient owner might obtain the state assets even though more efficient owners are present as potential buyers. In the model, a state-owned enterprise is initially located in the market. It is assumed that the government will liberalize the market by: (i) selling the state assets, and (ii) allowing for new plants to be opened by private investors, i.e. abolishing investment restrictions. In the first stage, the state assets are sold at an auction, with two potential buyers. There is an efficient owner, for example a firm whose firm-specific assets match well with the assets for sale, the most efficient firm in a related industry or the market leader in the world market. There is also an inefficient owner, which could be a less efficient firm, a firm whose firm-specific assets do not match well with the assets for sale, a former worker or the former management team, or an inactive pension fund. The efficient owner is assumed to face lower variable production costs when using the state assets, due to its access to superior technology or knowledge. In the second stage, owners may invest by setting up a new plant, where the efficient technology is used. Here, it is assumed that the inefficient owner will now have the time to introduce a more updated or appropriate technology, and may do so if this is profitable. In the third stage, the owners compete in Cournot

[2]Many countries also announce substantial forthcoming privatizations. Planned privatizations suggest that the privatization process will remain strong through continued activities in Europe and Asia. Examples of countries with large privatization plans are China, Japan, Portugal, Thailand and Turkey (OECD, 2000).

[3]Estrin (2002).

[4]Djankov and Murrell (2002) conclude: "Privatization to workers is detrimental, privatization to diffuse individual owners has no effect and privatization to funds or foreigners has a large positive effect."

[5]Carlin and Landesmann (1997).

[6]In practice, different types of measures have been used to privatize former state-owned enterprises. Several western countries employed various kinds of auctions to sell state-owned enterprises to the highest bidder. In some transition countries, a substantial fraction of the shares of all firms was given to the general population for free. Most privatization programs combined several elements of these basic methods; see Schmidt and Schnitzer (1997).