Lecture 8. Privatization
Lecture outline

• Definitions of privatization
• Goals of privatization
• State vs. private ownership
• Who should participate in privatization?
• Speed of privatization
• Specific methods of privatization
• Other issues related to privatization
• Empirical work on privatization
Definitions of privatization

**Broad definition:** increased share of privately owned productive assets in the economy

**Narrow definition:** transfer of state-owned assets to private owners
## Control rights vs. cash flow rights

<table>
<thead>
<tr>
<th>Politicians have control rights</th>
<th>Private owners or managers have control rights</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Government receives cash flows</strong></td>
<td><strong>State ownership</strong></td>
</tr>
<tr>
<td><strong>Private owners receive cash flows</strong></td>
<td>Privately owned regulated firm</td>
</tr>
</tbody>
</table>
Goals of privatization

• Improving efficiency of the economy by facilitating the workings of markets
• Improving efficiency of specific enterprises
• Political goal of creating constituency for market reforms and making these reforms irreversible
Improving efficiency of markets

• Private ownership is necessary for prices to reflect information about relative scarcities
• Private ownership is necessary (but not always sufficient) for demonopolization
Improving efficiency of specific enterprises

• Privatization strengthens profit-making orientation of enterprises and makes it more difficult for politicians to use firms to advance political goals

• However, privatization may also make profit-making incentives too strong from social efficiency point of view

• Privatization alleviates agency problems
State vs. private ownership

• Standard arguments for state ownership of individual firms
  – Public goods, externalities
  – Monopoly

• Contracting and regulation as a means of dealing with the above problems
Arguments against state ownership

Private enterprises are usually better at cost reductions and innovation (Why?)

Objection: sometimes cost reductions are accompanied by *non-contractible* deterioration of quality and might be undesirable (examples: schools, prisons)

Private ownership might still be preferred if competition is effective or if reputation is important
State vs. private ownership (cont.)

- Given **benevolent government**, state ownership is superior to private ownership if
- Opportunities for cost reductions that lead to non-contractible deterioration of quality are significant **AND**
- Innovation is unimportant **AND**
- Competition and consumer choice are ineffective **AND**
- Reputational mechanisms are weak
State vs. private ownership (cont.)

• What if the government is not benevolent (i.e., corruption and/or patronage occur)?

• Patronage means that politicians use firms to further political goals; this argues against state ownership

• Corruption makes both state ownership and regulation by the state problematic → outright privatization might be best

• If regulation is necessary, government ownership is preferred where weak incentives are desirable, market mechanisms are limited and corruption is high
Who should participate in privatization and how much should they pay?

• Should state-owned assets be privatized via sale or via giveaway?
• Sale: should anybody be allowed to bid? Should anybody get discounts?
• Giveaway: Should insiders have privileged access?

(Arguments: Coase theorem, incentives, entrepreneurial skills, “fairness,” political feasibility, revenue considerations)
Speed of privatization

• For markets to work, it should be done fast
• However, there are constraints:
  – Administrative difficulties
  – State budget might suffer, because it might be more difficult to collect taxes from private firms than from state-owned enterprises
  – Potential for unemployment → need to pay unemployment benefits → taxes need to be raised on private sector → lower ability of private sector to absorb newly unemployed
Privatization methods

- Most countries combined several methods
- Sale to insiders (Poland, Hungary)
- Sale to outsiders (E. Germany, Hungary)
- Giveaway to insiders (Russia)
- Giveaway to all citizens (Czech Republic)
- Tradable vouchers (Russia)
- Non-tradable vouchers (Czech Republic)
- Restitution
Distribution by privatization methods (as of 1997)

<table>
<thead>
<tr>
<th></th>
<th>Sale to domestic investors</th>
<th>Sale to foreign investors</th>
<th>Equal access vouchers</th>
<th>Insider: MBO &amp; ESOP</th>
<th>Other</th>
<th>State property</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech R.</td>
<td>10</td>
<td>10</td>
<td>40</td>
<td>5</td>
<td>5</td>
<td>30</td>
</tr>
<tr>
<td>Hungary</td>
<td>12</td>
<td>45</td>
<td>0</td>
<td>3</td>
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<td>20</td>
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<tr>
<td>Poland</td>
<td>2</td>
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<td>18</td>
<td>20</td>
<td>10</td>
<td>40</td>
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<tr>
<td>Romania</td>
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<td>5</td>
<td>20</td>
<td>10</td>
<td>0</td>
<td>60</td>
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<tr>
<td>Slovakia</td>
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<td>7</td>
<td>25</td>
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<td>Slovenia</td>
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## Economic consequences of privatization methods

<table>
<thead>
<tr>
<th></th>
<th>Improve corporate governance</th>
<th>Revenue for restructuring</th>
<th>Revenue for government</th>
<th>Low admin. costs, fast</th>
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</thead>
<tbody>
<tr>
<td>Sale to insiders</td>
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<td>-</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Sale to outsiders</td>
<td>+ -</td>
<td>+</td>
<td>+</td>
<td>-</td>
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<tr>
<td>Giveaway to insiders</td>
<td>-- +</td>
<td>-</td>
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<td>+</td>
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<tr>
<td>Giveaway to pop-n</td>
<td>-</td>
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<td>+-</td>
</tr>
<tr>
<td>Restitution</td>
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</table>
### Political and distributional consequences of privatization methods

<table>
<thead>
<tr>
<th>Method</th>
<th>Perception of fairness</th>
<th>Wealth and income distribution</th>
<th>Political feasibility</th>
<th>Creation of political base for reform</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale to insiders</td>
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<td>-+</td>
<td>+-</td>
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<tr>
<td>Sale to outsiders</td>
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Other issues

• Spontaneous privatization
• Restructure before or after privatization?
• State-owned enterprise (SOE) debt
• Environmental issues
• Bankruptcy laws and procedures
• What to do with remaining SOE’s?
• Anti-monopoly policy
• Joint state & private ownership
Spontaneous privatization

• Formal privatizations are often delayed to make sure they are done right
  → assets are privatized spontaneously via rent-seeking efforts

• Rent-seeking is costly (like queuing) but it might allocate assets reasonably well IF the same people who are good at rent-seeking are good at running firms
Enterprise restructuring

• Defensive vs. strategic restructuring

• Main advantage of strategic restructuring is the possibility of significant improvement of enterprise performance

• Possible disadvantages of strategic restructuring:
  – Costs
  – Uncertain outcome
Enterprise restructuring (cont.)

• Restructure before or after privatization?
• If private investors are more risk averse than the government, it might be a good idea to restructure before privatizing
• But generally, private owners presumably would know better how to restructure
• Example (problematic): Midterm 2, 2005, problem D.1
Anti-monopoly policy

• Problem with monopoly
• Regulation vs. demonopolization
• Privatization implies some demonopolization
• Regulating monopoly may be difficult if monopolists have political power
• Market forces act against monopoly
• Anti-commons: (Example: D.2, Midterm 2, 2005)
Joint state-private ownership

• Clear property rights are usually thought to work best
• However, in weak institutional environment (poor property rights enforcement, weak rule of law) joint state-private ownership might work better
• Township-village enterprises in China:
  – Private owners manage most activities
  – Local government owners help with bureaucratic problems and protect from central government
Limitation on foreign ownership

• Should foreigners be allowed to bid on enterprises privatized via sale to outsiders? What might be the reasons for limiting foreign ownership?
Empirical work on privatization

• Goals of the analysis:
• the effect of privatization on enterprise performance
• factors that determine post-privatization performance:
  – type of ownership (outsiders, insiders, and the subclasses of these);
  – new human capital;
  – hardening of budget constraints;
  – product competition;
  – the role of institutions
Empirical work (cont.)

• Basic approach:
• Firm-level data
• Estimating a regression equation:
  \[ Y = \beta_0 + \beta_1 x_1 + \ldots + \beta_n x_n + \gamma P + \varepsilon, \]
where \( Y \) is a measure of enterprise performance, \( P \) measures the reform conducted at the enterprise (e.g., ownership, change of management, hardening of budget constraints, etc.), \( x_1, \ldots, x_n \) are control variables, and \( \varepsilon \) is an error term. The main goal is to estimate \( \gamma \).
Empirical work (cont.)

• Technical issues:
  – Measurement of dependent variable;
  – Measurement and appropriateness of controls;
  – Selection bias, endogeneity
Empirical work (cont.)

How do we measure Y? Ideally, Y should measure efficiency.

With respect to publicly traded corporations in a well-functioning market economy, we can look at share values prior to reform P and after it. But for assets that have been privatized, we cannot do this even in market economies, because pre-reform values are not available. Moreover, in economies in transition, there might not be sufficient number of publicly traded companies and there are doubts about the efficiency of those markets.
Empirical work (cont.)

Usually, Y is measured by such “quantitative” indicators (usually based on accounting measures) as total sales, revenues, or value added, or the same indicators per worker or growth rates of these indicators. (“Profit” and similar measures are rarely used because it’s difficult to do pre-reform comparisons, but also because it is not always clear what profits mean in those economies.) Alternatively, Y can be a “qualitative” or indirect measure such as the extent of change in suppliers or of product innovation, the amount of wage arrears, etc.
Selection bias. If Y and P are both affected by some factor that is not included in X, we might get biased results. For example, suppose enterprises that require large investments but are likely to perform well after that are sold to foreign owners because only they have sufficient access to capital to make those investments. Then, we would observe foreign-owned enterprises being restructured and doing very well afterwards as measured by Y, but there would be no causal relationship between foreign ownership per se and performance (or restructuring). Instead, it would simply be the result of foreigners getting enterprises that would benefit most from capital intensive restructuring. (Another example would be privatization of better enterprises through sale to outsiders.)
Empirical work (cont.)

- Controls (X’s) are usually dummy variables for sector, region and year (in panel data); level of competition, softness of budgets (i.e., subsidies from the state); sometimes capital and labor (if output is a dependent variable); enterprise size, etc.

- There are problems with some of these variables with respect to measurement (how to measure level of competition, for instance?) and endogeneity (e.g., subsidies from the state are provided usually to poorly performing enterprises, and thus causality goes from poor performance to subsidies, not from soft budget constraint to poor performance)
Empirical work (cont.)

• Results of empirical work:
• 1. **State vs. Private ownership**: privatization improves performance, although the effect in the CIS (including Mongolia, i.e., “three generations under socialism” countries) is “limited” or even non-existent. This conclusion is robust with respect to different specifications. In general, the effect of privatization is stronger in the non-CIS than in the CIS countries.
• Very recent research indicates that while privatization in Russia had negative effects in terms of productivity in the early years of transition, it had significant positive effects starting in 2002, so that by 2005 the effects in Russia were similar to those in Eastern Europe in the mid-1990s.
Empirical work (cont.)

- **2. Different types of owners:** The ranking (from worst to best) is (1) diffuse individual, (2) workers, (2) banks, (4) commercialized state, (5) managers, (6) blockholders, (7) investment funds, (8) foreign. The last four are not statistically different.

- There is also **regional variation.** It appears that workers and diffuse outsiders are significantly more effective in the non-CIS region while banks and concentrated individual owners are more effective in the CIS. This is consistent with an institutional story (good corporate governance allows for diffuse ownership and worker ownership to work well while poor institutions require concentrated ownership).

- One conclusion from this is that weaker effect of privatization in CIS is due to two factors: (1) ownership of generally less effective groups (workers, insiders) is more common in CIS, and (2) these groups need institutional help that is lacking in the CIS.
Empirical work (cont.)

3. **The role of managers: new human capital or incentives?** Why does privatization work? Is it because privatized enterprises are able to find better managers (better matches between managers and capital assets) or because of better incentives. Apparently, manager turnover is much more important. It works even in state-owned enterprises. Note, however, that turnover might also improve incentives, because “hanging concentrates the mind.”
Empirical work (cont.)

- **4. Hardening of budget constraints**: hard budgets have positive and very significant effect in the non-CIS group, but insignificant effect in CIS group. One reason why soft budget constraint (SBC) might not lead to worse performance as measured in these studies is that SBC is often accompanied by other assistance from the state such as tariffs or barriers to entry. That can result in higher prices and higher accounting measures such as labor productivity, etc. Studies that use measures that are less likely to be affected by barriers to entry, etc., do indicate a significant deterioration of performance due to SBC.
Empirical work (cont.)

• 5. *Product market competition*: product competition improves managerial performance, because it makes it easier to provide appropriate incentives to managers and it improves resource allocation via entry and exit. The effect of competition, particularly foreign, is quite strong and significant in non-CIS, but insignificant, although still positive in CIS countries. This might be in part a result of much more dramatic increase in openness in non-CIS than in CIS countries. Also, it might be due to underdeveloped internal transport infrastructure in Russia, so that the “country” is open but the regions are not. But domestic market competition seems to have significant positive effect in the CIS, including Russia.
Empirical work (cont.)

• **6. The role of institutions:** using enterprise-level data, it’s hard to find explicit evidence of the role of institutions. It is even difficult to study the effect of institutions, because they apply to all enterprises in a given country. One approach has been to look at relative performance of enterprises, for which contract enforcement has different importance. For example, enterprises that need more variety in their suppliers would be more affected by contract enforcement problems. There has been little empirical support for this factor. However, the indirect evidence presented above (e.g., weaker effects of privatization in the CIS) suggests that institutions are important.
Overall conclusion

• Privatization “works” (improves efficiency of the economy and of specific enterprises);

• Fast privatization of small and medium enterprises is absolutely necessary for successful transition

• It is less important to privatize large enterprises quickly