A survey of privatization

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Abstract

Literature shows that privatization is an effective device to enhance the efficiency of SOEs. However, different strategies for privatization may bring different results. After the financial crisis 2008, privatization in the world becomes more active. To be successful with privatization programs, governments need to choose the appropriate method of privatization. This article aims to present an overview and evidence of privatization on firm performance and behaviors surrounding the events, which may provide policymakers a basis for more effective privatization programs and suggest some directions for further studies on this topic.

1 . Introduction

There are two main reasons why state-owned enterprises' (SOEs) operation is inefficient compared to privately-owned firms: social objectives (political view) and lack of effective monitoring for manager actions (managerial view) (Gupta, 2005). Governments often pursue social goals such as job creation and have weak incentives for profit maximization. Meanwhile, private owners have larger incentives for financial returns than governments, and their objectives are less likely affected by political interference (Boycko et al., 1994; Shleifer & Vishny, 1994). From managerial view, the lack of

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effective monitoring for manager actions makes SOEs face obstacles in improving firm performance. There is no stock price as a public signal about managers' ability, as well as incentives created by equity-based compensations.

Privatization commonly brings two structural changes, which can solve the problems arising from political and managerial incentives: control rights transfer and stock listing. Control rights transfer brings private investors into the management of firms, while stock listing makes managers under market monitoring. Nevertheless, different strategies for privatization bring different results (Estrin & Pelletier, 2018). The privatization of SOEs in urban areas is different from those of state-owned enterprises in rural areas (Dong et al., 2006). Full privatization brings different effects on the firm performance and behavior compared to partial privatization (Beck, Crivelli, et al., 2005; Dong et al., 2006; W. Li & Xu, 2004). The participation of foreign investors can also lead to better performance after privatization (Bonin et al., 2005a, 2005b)...

After the financial crisis 2008, privatization in the world tends to more actively take place. Revenue from privatization increased by 2.4 times from $110 billion in 2008 to $266 billion in 2016 (OECD, 2018). The objectives of privatization according to the OECD (2018) survey are to improve market structure and efficiency of economy, to increase resources to implement fiscal policies, to improve industry and business performance, and to shift gradually economic activities to the private sector. To be able to successfully conduct privatization, governments need to choose the appropriate method of privatization.

This article would like to present an overview and evidence of privatization on firm performance and behaviors surrounding the events, which may provide policymakers a basis for more effective privatization programs and suggest some directions for further studies on this topic.

The rest of the paper is organized as follows. Section 2 presents a review on privatization and firm performance. Section 3 surveys the corporate behavior surrounding privatization. Finally, section 4 is the conclusion.

2. Privatization and firm performance

Why does privatization bring benefits to SOEs?

Various studies show that privatization is an effective instrument to increase firm performance (Beck et al., 2005; Bonin et al., 2005; Boubakri et al., 2005; Boubakri & Cosset, 1998; Brown et al., 2016; Chen et al., 2021; Clarke et al., 2005; Gupta, 2005; Jiang et al., 2013; Kubo & Phan, 2019; Li et al., 2019; Megginson et al., 1994; etc.). Privatization commonly brings two structural changes, which can solve the problems arising from political and managerial incentives: control rights transfer and stock listing. Control rights transfer brings private investors into the management of firms, while stock listing makes managers under market monitoring.

Effective period of time

Early studies on privatization generally focus on three-year intervals to examine privatization effects. For instance, Megginson et al. (1994) adopt univariate analyses for 61 firms from 18 countries to investigate the performance effect of privatization. They compare the mean and median of raw three-year accounting measures before and after privatization. The study finds that privatization enhances real sales, profitability, and operating efficiency three years after the event.

Since Megginson et al. (1994) just adopt raw accounting measures, macro-economic factors might affect the results, Boubakri & Cosset (1998) use international data of 79 firms to re-examine privatization effects on financial and operating performance. Adjusted variables are adopted to control for macro-factors besides raw measures. The findings in this study confirm that the positive effect of privatization on SOEs' performance can be observed in three years of post-privatization. One possible reason why the early studies do not investigate year-by-year performance surrounding privatization is that the number of privatized firms in this period is small. Aggregate observations in the three years help to increase the sample size.

To clarify the time when privatization realizes its effect, Claessens & Djankov (2002) use a sample of 6000 privatized and state-owned manufacturing enterprises in seven Eastern European countries and find that in the first two years after privatization, firm productivity growth is similar to that of SOEs. The significant outperformance of privatized firms is observed from year 3 onwards, indicating that firms need some time to restructure their operation, and to show significantly positive changes in their performance.

With the development of advanced econometric methods as well as the global expansion of privatization, the estimation of the long-term effect of privatization becomes more feasible. The recent studies generally adopt regression analysis to obtain the privatization effect in the long run and control for various firm characteristics as well as macro-economic factors, which potentially affect firm performance. As shown in the previous section, the effect of privatization on firm performance remains positive even when we put stricter conditions on our estimations.

Effect of privatization methods

Privatization, in any form, generally improves the performance of SOEs. However, different privatization methods might bring different results.

+ *Full and partial privatization*

Many previous studies focus on full privatization and mainly define that privatization occurs when governments transfer more than 50 percent of their ownership to private sectors (for example Boubakri & Cosset (1998); Dewenter & Malatesta (2001)). The performance effect in these cases is widely proved as positive. SOEs that are fully divested face less pressure on the implementation of social goals, such as employment security, and these firms can, therefore, enjoy the benefits of transferring the objective to profit maximization. Since the governments keep control of the SOEs after partial privatization, the firms still have to ensure the social objectives as required by the governments and may experience few performance changes. This may be the reason why literature, especially the earlier studies, does not consider a firm as privatized when governments still hold more than 50 percent of ownership.

Partial privatization, however, catches the attention of researchers in later studies. Sun & Tong (2003) examining share issue privatization (SIP) in China, most the firms are partially privatized, finds that SIP effectively enhances earnings and real sales. The positive effect, however, is limited when compared with privatized firms in other countries. They argue that partial privatization may be a plausible reason for the limitation. They, however, do not point out why partial privatization can benefit firms while governments still keep control rights.

To solve the limitation of Sun & Tong (2003), Gupta (2005) shows that partial privatization in India can be beneficial when privatized firms are listed on the stock market and experience strict market monitoring. This study explicitly indicates that although partially privatized firms are under the control of governments and obliged to conduct social tasks (political view), market supervision through share prices creates incentives for management to find ways to increase operating efficiency (managerial view). The empirical results of the Indian privatization program show that partial privatization positively improves profitability and productivity. Although Gupta (2005) attributes the positive impact of partial privatization to strict market monitoring, the question of whether partial privatization without listing generates a positive effect needs to be exploited further. It is because Tan et al. (2020) show apart from stock price, improved alignment of the benefits of governments with those of private owners in partial privatization has positive effects on firms' innovation.

Since both full and partial privatization improve firm performance, many studies attempt to compare the effect of the two methods. The findings reveal that the full divestment of state ownership in SOEs brings a larger positive effect than when governments still keep control rights (Beck, Crivelli, et al., 2005; Dong et al., 2006; W. Li & Xu, 2004). Fully privatized firms can focus on for-profit restructuring like private enterprises. Meanwhile, privatized enterprises, in which government still holds a controlling stake, are likely to still have to ensure the social goals set by the government.

+ *Strategic shareholder offering and public offering*

Through privatization, governments divest a portion of shares (assets sales) or issue new shares (share issue privatization − SIP) to private investors. Although OECD (2018) shows that strategic shareholder offerings are used less commonly than public offerings, Clarke et al. (2005) and Megginson (2005) show that offering to strategic investors brings higher efficiency than offering to the public. This may come from the fact that strategic shareholders, who are often large investors and desire to own a large number of shares in privatized firms, help to reduce agency costs between owners and management compared to a large number of minority shareholders. Besides, strategic shareholders often have clear corporate reform plans, which make privatization more effective.

+ *Offering to foreign investors and domestic investors*

Foreign investors improve the performance of SOEs in transitional economies by introducing advanced technologies to modernize their operations (Bonin et al., 2005a, 2005b). Also, foreign owners bring better profit efficiency to privatized firms than domestic investors do (Bonin et al., 2005b). Foreign banks often have higher risk tolerance, so they can undertake projects with greater risk, thereby being able to bring a higher added value to the business (Azam et al., 2004). Cull & Spreng (2011) show that the sale of state-owned banks in Tanzania to foreign strategic investors will increase profitability, reduce non-performing debts, and increase the ratio of loans to total assets. To sum up, the literature suggests that developing countries and transitional economies achieve more positive effects from the participation of foreign investors in privatization through technology introduction, as well as better financial and risk management abilities.

Privatization and firm location

While the previous studies do not show heterogeneity of privatization effects across different locations, Dong et al. (2006) are among the first papers that examine the issue. By examining a sample of 165 rural and urban SOEs in China, they find that the government tends to choose the lowest performance firms to privatize in the urban area, while such a selection bias is not found in the rural sector. Pareto efficiency may explain the selection since inefficient firms have more room for improvement after privatization at lower social costs (Gupta et al., 2008). Besides, employees may support the privatization of falling firms in the expectation of receiving their wages on time. Meanwhile, employees in rural SOEs have less efficient devices to prevent privatization, the government is easier to privatize all these SOEs. Also, since rural SOEs generally are small in size, they are the targets of the "let go of the small" policy of the Chinese government.

Dong et al. (2006) also indicate the difference in privatization effects on the two types of SOEs. Privatization shows strong evidence for productivity and profitability performance improvement for urban SOEs, while the positive effect is just found for some performance measures. One potential explanation provided is that urban SOEs have softer budget constraints and stronger political intervention than their peers. They, however, do not show the evidence for their argument. Also, one potential limitation in the performance comparison between the two groups is the selection bias for urban privatized firms, as they indicate. While the government seems to privatize all rural SOEs, they only privatize inefficient firms in urban areas. This bias may make large changes in the performance of urban privatized firms since low-performance firms may have more room to improve.

3. Privatization and corporate behaviors

The previous sections show that privatization generally increases firm performance. Given that privatization is an effective device to enhance the efficiency of SOEs, it is also important to examine the changes in firms' behaviors surrounding the event. This section reviews the literature on firms' behaviors according to three main corporate decisions: investment and lay-off, financing, and payout.

3.1. Privatization and investments

SOEs often overinvest to meet social objectives ordered by governments (Boycko et al., 1996; He & Kyaw, 2018; Shen et al., 2016; Su et al., 2013). They are also taking more risks due to benefits provided by government protection (Faccio et al., 2006; Merton, 1977; Zhu & Yang, 2016). Meanwhile, privatized firms, which care more about financial returns, are likely to divest from non-profit investments. Besides, soft budget constraints are an obstacle for privatized firms (Megginson et al., 2014), which makes firms refrain from conducting investment. Boubakri et al. (2020) show that state ownership is positively associated with the level of risk-taking. There are, however, few studies that support this argument.

Megginson et al. (1994) argue that after privatization, firms should increase capital expenditure since they have better access to private debt and easier to issue new shares. Since private investors aim at profit maximization, they are incentivized to invest more. Privatized firms also need to improve their competitiveness, which requires more investments (Megginson et al., 1994). Many studies support this view (Boubakri & Cosset, 1998; D'Souza et al., 2005; D'souza & Megginson, 1999; Gupta, 2005; Megginson et al., 1994).

3.2. Privatization and lay-off

One of the most common behaviors of SOEs after privatization is lay-off. Since employment creation is an important social objective of governments, governments may accept surplus employees at the expense of performance damage. The involvement of private investors with profit maximization objectives makes firms focus on employee productivity improvement. Surplus employees are likely to be laid off after privatization. Various empirical studies support this argument (Azmat et al., 2012; Barberis et al., 1996; la Porta & Lopez-de-Silanes, 1999; Okten & Arin, 2006).

3.3. Privatization and financing

Literature suggests that privatization has a negative effect on firm leverage (Boubakri & Cosset, 1998; D'souza & Megginson, 1999; Mathur & Banchuenvijit, 2007; Megginson et al., 1994). Due to the loss of government guarantees, the cost of debt is likely to increase for privatized firms. Besides, privatized firms are easier to get access to the stock market. These reasons potentially lead to a decrease in leverage after privatization (Boubakri & Cosset, 1998).

Borisova & Megginson (2011) shows empirical evidence of the increase in the cost of debt for privatized firms. They use the gap in yield to maturity of the firm bond and government bond as a proxy for the cost of debt. A reduction in state ownership by one percent increases the cost of debt by 0.0075% on average during the privatization period due to the loss of government protection, and higher risk surrounding ownership change. However, one novel finding is that fully privatized firms eventually experience lower costs because of performance improvement.

Since the data on debt structure is limited in the past, Boubakri, N., & Saffar, W. (2019) is among the first paper that explicitly examines privatization and debt choice. They find that due to soft budget constraints, firms with higher state ownership use more bank debts. Also, since agency costs of firms with high state ownership are more severe, these firms tend to use debt with long maturity and low collateral.

3.4. Privatization and payout policy

Payout surrounding privatization appears to catch the least attention of scholars. Few studies examine the issue though privatization potentially leads to changes in firms' payout policy. Data availability seems the possible reason for the limitation since information on dividend amount, declaration date, ex-dividend date, date of record, or pay date is generally not required for SOEs to disclose in financial reports. Firms privatized without listing even do not have to publicly inform the dividend plan. Besides, the payout ratio of SOEs is extremely hard to get access. Conducting univariate analyses of payout surrounding privatization year is challenging.

Since privatization makes firms more sensitive to financial constraints, privatized firms may be forced to rely on internal funds. In other words, firms may reduce payout ratio after privatization. However, few studies support this view. Megginson et al. (1994) are among the first studies investigating privatization effect on dividend payment. They argue that governments may have less demand for dividends than private investors. Besides, dividends are a common response for firms with a large number of minority shareholders (in the case of SIP). They find that privatization increase dividends over net income and dividends over sales. This finding is also supported by the later studies (Alexandre & Charreaux, 2004; Boubakri & Cosset, 1998; Mathur & Banchuenvijit, 2007; Sun & Tong, 2002). Most of these studies, however, only use univariate analysis. Further studies with control for firm characteristics and macroeconomic factors are potential to provide more insights into dividend policy surrounding privatization.

4. Conclusion

Various studies of privatization show theoretical and empirical evidence of a positive impact on firm performance. Literature indicates that the performance improvement can be recognized within three years after privatization, as well as in the long run. In general, privatization, in any form, brings benefits to SOEs but the magnitude of the effect depends on the forms of privatization. Full privatization brings a larger effect on firm performance than partial privatization. Transferring state ownership to foreign investors enables SOEs to improve operating performance better than transferring to domestic ones. Strategic investors more effectively restructure firms compared to general public investors. Firm location seems to matter in privatization. Firms in urban areas experience more noticeable improvement after privatization compared to those in rural areas. These insights may provide policymakers with a basis for more effective privatization programs.

Further research can be conducted to contribute to the literature on privatization. First, since privatization generally combines both ownership transfer and stock listing, the findings in previous studies may be confounded by the listing effect. The separation between these effects is a potential direction. Second, partial privatization seems not to catch much attention of researchers. Few studies examine the issue, thereby this may be potential for further studies. Third, in some countries, SOEs issue shares to their employees to conduct privatization. The effect of this method, however, has not been well examined by literature. A further study on this issue may give a novel contribution.

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