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Equitisation and stock-market development

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Part II:

The Process of Equitisation in Vietnam

Chapter 2

An Overview of the Literature on Privatisation

2.1. Introduction

Over the last two decades, privatisation has been a key component of structural reform programmes in many countries, especially in developing and transition countries. The objectives of these programmes are to improve microeconomic efficiency, foster economic growth and reduce public debt through the elimination of unnecessary subsidies (Sheshinski and López-Calva, 2003). At the same time, privatisation has become an interesting study subject for many academics. This chapter aims at reviewing both the theoretical and empirical literature on privatisation in order to provide a background for the empirical study on this issue, which will be conducted in Chapter 4 and Chapter 6.
The remainder of this chapter is organised as follows. Section 2.2 gives some definitions of privatisation, while different privatisation methods and their pros and cons are presented in Section 2.3. Section 2.4 discusses the efficiency of public versus private ownership. The empirical literature that measures the impact of privatisation on firm performance is reviewed in Section 2.5. The macroeconomic effects of privatisation are summarised in Section 2.6. Finally, Section 2.7 concludes the chapter.

2.2. Definitions of privatisation

Privatisation is a wide concept, and it has been differently defined in the literature. Some authors narrowly define privatisation as the sale of state-owned assets. Specifically, Weiss (1988) states that privatisation is the process of converting ownership of an asset from the state to the private sector. In addition, Nellis (1998)

defines privatisation as “a transfer of ownership such that a majority of the shares or equity in an enterprise passes from state or public ownership into private hands”. Moreover, Ramamurti (2000) stresses that privatisation is any measure that transfers some or all of the ownership and/or control over SOEs to the private sector. Finally, according to the World Bank (1996) privatisation is defined as “the divestiture by the state of enterprises, land or other assets.”

In a broad sense, privatisation is seen as a phenomenon encompassing interconnected activities that reduce government ownership and control of enterprises and that promote private- sector participation in the management of state-owned enterprises. Specifically, according to Ramamurti (2000), privatisation is any measure that increases the role of the private sector in the economy - for example, through deregulation, which permits private entry into markets previously reserved for SOEs, economic liberalisation, which exposes SOEs to greater competition, or institution building, which improves the functioning of private firms and markets. Similarly, Hartley and Parker (1991) define privatisation as “the introduction of market forces into an economy in order to make enterprises work on a more commercial basis”. Furthermore, Cook and Kirkpatrick (1988) define privatisation as “a range of different policy initiatives intended to change the balance between the public and private sector and the services they provide”. Specifically, they distinguish three main approaches to privatisation: a change in the ownership of the enterprise, liberalisation or deregulation, and a transfer of goods or services from the public to the private sector even if the government retains ultimate responsibility for supplying the service. Weiss (1988) defines privatisation as the general removal of state control on economic activities. This policy consists of not only changes of ownership but also actions to remove regulatory constraints and general attempts to expose more economic activities to the rigours of market forces.

From a transition point of view, Blommestein et al. (1993) define privatisation as “any transfer of ownership of a state enterprise to other agents, which results in their effective private control of the business”. They argue that privatisation does not require a majority stake to be held by any private owner or group of owners; it is also compatible with some shares being retained by the state. This definition is used in this study because it is very close to the definition of the Vietnamese version of privatisation (equitisation) that will be covered in the next chapter.

2.3. Methods of privatisation: pros and cons

This section summarizes some alternative methods of privatisation that have been widely used in transition economies. Specifically, these methods include

restitution, sales to outsiders, management-employee buyouts, leasing and management contracts, and voucher privatisation. The pros and cons of these methods are briefly reviewed later in this section.

2.3.1. Restitution

Restitution involves the return of state assets (buildings, real estate, and agricultural land) to their rightful owners where the prior acquisition of the property is deemed unjust. Bornstein (1997) argues that on moral grounds, it is necessary to redress the worst examples of past injustices. Moreover, restitution could rebuild public confidence in a country's legal enforcement of property rights. However, certain claims of restitution can be complicated, thereby prolonging the privatisation process unnecessarily. Accordingly, it could deter the overall privatisation process by creating an atmosphere of uncertainty about ownership rights (Havrylyshyn and McGettigan, 1999).

2.3.2. Sales to outsiders

Sales to outside investors can be classified as direct sales and equity offerings. Practically, direct sales have been employed in most transition economies while equity offerings have been extensively used in developed countries.

Direct sales

At the start of the transition process, most countries intended to privatise by selling state enterprises case by case as going concerns (Gray, 1996). Specifically, direct sales involve the outright sale of state assets through auctions. This technique is likely to be suitable in transition economies because it helps to overcome the problem of the underdeveloped state of domestic capital market in theses countries. The initial advantage of direct sales is that corporate governance is likely to be more effective with outside owners. Moreover, this method can help the government to select good investors, who evaluate the firms at the highest value and have the best skills to manage the companies. Finally, this approach can raise revenue for the government that usually faces a budget deficit in the early years of transition.
However, this method has several drawbacks. First of all, the sales can be stalled due to lack of domestic capital, reluctance of foreign investors and poor quality of company information in transition countries (Havrylyshyn and McGettigan, 1999). In addition, this method tends to be costly and time-consuming because of the complex administrative tasks. For instance, the difficulty in firm evaluation, for

reasons of inadequate accounting system and general political and economic uncertainty, makes the process complicated. Moreover, the power of pre-existing stakeholders, such as workers and managers, usually prevents the consideration of privatisation through direct sales (Pohl et al., 1996). Finally, Earle and Telegdy (2002) argue that, due to lack of an objective criterion and non-transparency of the process, selection decision can be easily manipulated, creating the appearance of corruption.

Equity offerings

The second form of sales to outsiders involves equity offerings on stock exchanges (share-issue privatisation). Share-issue privatisation can be defined as a method of selling state-owned enterprises by offering some or all of the government's equity in a state-owned enterprise to investors. The objective of this method is to involve small individual and larger institutional shareholders in the purchase of state-owned assets. This approach has been widely used in the developed economies, but rarely in transition economies (Havrylyshyn and McGettigan, 1999). This can be explained by the fact that availability of highly-developed financial markets in the developed economies makes share-issue privatisation easier than in transition economies where stock markets are mostly in an underdeveloped state.
The advantage of this method is that it can be used to promote wide share-ownership as all members of the public are invited to participate in the offerings. However, privatisation solely conducted through public offerings has some disadvantages. Indeed, according to Jenkinson (1998), pricing the shares in public offerings could be difficult due to lack of information. Moreover, because the aim of share issues is to encourage broad participation, the state can incur large marketing costs to advertise the offer.

2.3.3. Management-employee buyouts (insider privatisation)

Management-employee buyouts involve the sale, at a highly discounted price, or donation of the relevant SOEs' shares to a combination of managers and employees. Since most employees in transition countries have low incomes, and hence low savings, it is often arranged that they can borrow some money from state commercial banks for buying their state-owned company, usually at a preferred interest rate. In this case a repayment schedule is usually designed by the banks on the basis of expected profits of the company.
Insider privatisation has advantages in terms of speed and ease of implementation. Also, it is the closest to the communist ideology, saying that workers should own the assets of production. Moreover, Earle and Telegdy (2002) argue that employee

ownership results in increased work incentives of employees, which lead to a high effort level and small costs of monitoring. Finally, a benefit of employee ownership is the acceptance of lower wages if the firm is close to failure (Earle and Estrin, 1996).

On the other hand, management-employee buyouts have some risks and disadvantages, particularly in large-scale buyout programmes that include many unprofitable companies in need of restructuring (World Bank, 1996). The first disadvantage is that the benefits of public assets are unfairly distributed. For instance, employees in good firms enjoy valuable assets while those in money-losers receive little or nothing of value. Another disadvantage of insider privatisation is that it may lead to granting excessive wage increases, maintaining above-optimal employment levels and insufficient investment. Most importantly, according to World Bank (1996), management-employee buyouts would weaken corporate governance, particularly in transition economies where control of managers is less developed than in a full market economy, and capital markets cannot be counted on to enforce discipline. Moreover, insiders are generally unable to bring in new skills and capital, but may block subsequent outsider participation in the company. Finally, insiders-dominated enterprises face large difficulties in obtaining funds for investment due to information asymmetries and risks.

2.3.4. Leasing and management contracts

Leasing is a method in which the state signs a contract to lease the state-owned enterprise to the private sector. In this way, the lessee takes over the management of SOEs in return for lease payments. The principal objective of this method is to increase the role of outsiders in using state-owned assets. Moreover, the lease could immediately relax the burden on the public budget from current operating losses of SOEs, and even generate income for the government. Furthermore, leasing is usually used as an interim step towards full privatisation later. However, it has some problems in the sphere of enforcing the contracts and negotiating a proper fee.

In the management-contract method, the state signs a contract with external managers, giving them responsibility and power to manage state-owned companies. The rationality of this method is that the contract managers will improve the operating performance for the SOEs. However, payments to the external managers could become an additional burden on the government budget in the case where SOEs' performance would not be improved.

2.3.5. Voucher privatisation (mass privatisation)

Voucher privatisation was a popular privatisation method in Central and Eastern European countries. Voucher privatisation is a form of privatisation in which all citizens receive vouchers for free or at nominal fee from the government that can be used to purchase shares in any state-owned company. Voucher privatisation has both advantages and disadvantages.

Voucher privatisation is seen as the fastest way to transform state-ownership into private ownership. In addition, this method can help to overcome major problems of privatisation in transition economies, such as a shortage of domestic capital due to low savings and reluctance of foreign investors. Moreover, voucher privatisation is more transparent and fairer than privatisation by direct sales. Especially, the valuation problem of SOEs to be privatised, which is very common in the case of direct sales, can be avoided by using this method. Furthermore, according to Lipton and Sachs (1990), the fast pace of reform facilitated by voucher privatisation would add to the credibility of the reform programme, thereby bolstering its chance of success. Also, this speed does not give existing stakeholders enough time to form an effective opposition to the privatisation process. Besides, the widespread participation of a country's citizens under this method fosters a greater understanding of reform and creates the new "owner" class in favour of the reform process.

However, mass privatisation has some drawbacks. First of all, voucher privatisation can result in dispersed ownership that can have negative impact on corporate governance. In addition, voucher privatisation yields no revenue to the government.

In Vietnam, equity offerings have been mainly used as the method to privatise SOEs (equitisation). Moreover, direct sales, management-employee buyouts, leasing, and management contracts have been employed for very small and/or permanently loss-making SOEs.

2.4. The efficiency of state versus private ownership: theoretical review

Is public or private ownership more likely to be efficient? This question has induced a fair amount of debate in the literature on privatisation. Specifically, the literature on this issue can be divided into two branches: the social view and the agency view (LaPorta and López-De-Silanes, 1999). The social view is in favour of public ownership while the agency view supports private ownership. The theoretical arguments supporting these views are briefly summarised in subsections 2.4.1 and 2.4.2.

2.4.1. The social view

The social view argues that public ownership has several advantages over private ownership. Traditionally, state-owned enterprises are viewed as instruments capable of curing market failures by implementing pricing policies that take social marginal costs and benefits of production into account (Shapiro and Willig, 1990). Additionally, state-owned enterprises are controlled by governments, maximising social welfare and improving decisions of private firms when monopoly power or externalities lead to a divergence between private and social objectives (Shleifer and Vishny, 1994). For example, under non-competitive conditions, efficiency requires a single company to exist, but with the profit maximising objective, a private company will exploit monopoly power to charge too high a price and produce too low a quantity. This potential inefficiency can be solved by public ownership.

2.4.2. The agency view

Under perfect competition, more recent economic literature has taken a much less flattering view of public ownership and a more favourable view of private ownership. This literature stresses that principal reasons for privatisation are the existence of information asymmetries and incomplete contracting problems, leading to severe incentive problems and therefore serious inefficiency of state-owned enterprises. This is referred to as the agency view. Within this view there are two complementary strands of literature depending on whether the critical agency conflict is with the manager or with the politician (LaPorta and López-De-Silanes, 1999). The first, termed the managerial view, argues that SOE managers may lack high-powered incentives or are not properly monitored (Vickers and Yarrow, 1988). The second, termed the political view, stresses that political interference in the firm results in excessive employment, poor choices of product and location, lack of investments, and ill-defined incentives for managers (Shapiro and Willig, 1990; Shleifer and Vishny, 1994).

<u>The managerial view</u>

According to the managerial view, poor monitoring and lack of high-powered incentives result in inefficiency of state-owned enterprises. Managers (agents) in both private and state-owned firms are assumed to maximise their own utility, rather than that of the organisation or its owners (principals). In private companies, this divergence is reduced through both external mechanisms, such as markets for managers, the capital market and corporate control, and internal mechanisms, such

as managerial participation in ownership, reward systems, and the board of supervisors. However, these mechanisms are virtually absent in state-owned companies. Moreover, the owner-manager relationship is, in fact, broken-down into two agency relationships: the public as owners to politicians and politicians to managers, which effectively reduces the incentive for monitoring managers' behaviour.

The essence of privatisation and monitoring incentives is discussed in Yarrow (1986), Vickers and Yarrow (1991). Specifically, they argue that privatisation leads the manager to focus on profit goals because under private ownership management is directly supervised by shareholders. However, under public ownership, management is monitored by the government, which in turn can be viewed as an agent of the voting population. In addition, based on the assumption that shareholders expect the firm to maximize profits, Yarrow (1986) notes that managerial incentives depend on the separation of ownership and control, the availability of performance information to shareholders, the effectiveness of the takeover mechanism and legal constrains. Moreover, Laffont and Tirole (1991) analyse a specific trade-off between a public company and a private regulated one. The authors argue that benefits of private ownership stem from the assumption that shareholders will not expropriate investments of manager in the company's assets while the government could redeploy investments to serve social goals. Thus, the manager's investment incentives are better under private ownership. However, the cost of private ownership, according to this study, is that the company's manager has to report to two different parties: the regulators and the shareholders. Therefore, conflicts between the regulators' and the shareholders' objectives would create an incentive problem to induce inefficiency of the company.

The political view

The political view argues that poor performance of state-owned enterprises is caused by distortions in both the objective function that managers seek to maximise and the constraints they face, the so-called soft budget constraints. Specifically, managers of SOEs pursue strategies, such as excessive employment, that satisfy the political objectives of politicians who control them (Boycko et al., 1996). Moreover, politicians impose objectives on these firms that would help them to gain votes, but might conflict with efficiency (Buchanan, 1972; Niskanen, 1971). The reason why managers are able to do this without facing the threat of bankruptcy relates to the second distortion, the soft budget constraints. In any situation in which the firms have been engaged in unwise investments, it will be in the interest of the central government to bail the firm out using the public budget. The rationale for this rests on the fact that the bankruptcy of companies would have

a high political cost, the burden of which would have to be carried by a well-defined group, like unions. On the other hand, the cost of the bailout can be spread over the taxpayers, a less organised and larger group in society, with diversified interests and preferences. Therefore, the threat of bankruptcy is non-credible under public ownership (Sheshinski and López-calva, 2003).
Shapiro and Willig (1990) argue that the government is better informed about the firm under nationalisation than under privatisation. The reason is that ownership of the firm gives privileged access to its accounting system. From a welfare-maximising point of view, if the government is less informed, it is more difficult for the government to pursue its private agenda. Hence, privatisation is seen as a constraint on the "malevolent" government.
Further, Boycko et al. (1996) develop a model of privatisation to explain the relative inefficiency of state-owned companies and their performance improvements after privatisation. The assumption of their model is that performance of SOEs is poor because these companies pursue the objectives of politicians, such as excessive employment levels, rather than maximise efficiency. Indeed, the politicians prefer high employment levels because it helps them to gain votes. In addition, the manager of the SOE in this model is assumed to represent private shareholders. By allowing for corruption, the manager can bribe politicians for lower employment, and in some cases corruption can improve efficiency. However, a corruption contract is usually illegal and non-enforceable, so inefficiency of SOEs is not necessarily cured in this way. In the private company, the manager will set employment on the basis of efficiency considerations because the company's objective is to maximise profit. In this case politicians can use government subsidies to convince the manager to keep-up employment. It is likely that providing employment subsidies is politically more costly to the politicians than using foregone profits for this purpose because the flow of subsidies is more easily observable than foregone profits of a firm. This model explains why privatisation would lead to firm restructuring, even if subsidies remain to exist after privatisation.

2.5. The impact of privatisation on firm performance: a survey of the empirical literature

With the increase in privatisations over the last decades, the empirical literature concerning privatisation has also grown. Most empirical studies related to privatisation focus on examining the effect of privatisation on firm performance (for recent surveys, see Megginson and Netter, 2001 and Parker and Kirkpatrick, 2005). This section reviews the main empirical evidence on the impact of

privatisation on firm performance. It is important to note here that the survey is updated from Megginson and Netter (2001) and Parker and Kirkpatrick (2005). The survey concentrates on three categories of empirical studies involved in this field. Specifically, the first compares pre to post-privatisation performance of selected privatised companies while the second compares the performance of privatised firms to state-owned enterprises under reasonably similar conditions. The final category focuses on examining the effect of ownership structure on privatised firm performance.

2.5.1. Empirical studies comparing pre and post-privatisation performance

The empirical studies that examine the impact of privatisation on firm performance by comparing post to pre-privatisation financial and operating performance are summarised in Tables 2.1 and 2.2. Generally, all of these studies provide empirical evidence to support the proposition that privatisation improves the financial and operating performance of divested firms. Specifically, profitability, output (sales), operating efficiency and investment significantly increase following privatisation. In addition, these studies report that leverage significantly decreases after privatisation. It is important to note here that the effect of privatisation on employment is not unambiguous. Indeed, Boubakri and Cosset (1998) documents significant increases in employment while Megginson et al. (1994), D’Souza and Megginson (1999) and D’Souza *et al.* (2001) find insignificant changes in employment after privatisation. On the other hand, La Porta and López-de-Silanes (1999) and Harper (2002) report significant declines in employment during the post-privatisation period.

2.5.2. Empirical studies comparing performance of privatised firms with state-owned firms

Results of three empirical studies, which compare performance of privatised firms with state-owned firms under reasonably similar conditions, are summarised in Table 2.3. These studies employ a large sample of privatised and state-owned firms in Central and Eastern Europe to measure the impact of privatisation on sales revenues, productivity, and employment of firms. The empirical evidence obtained from these studies reveals that privatised firms generally outperform state-owned enterprises in terms of sales revenues, productivity, and cost per unit of revenue. Specifically, Pohl, Anderson, Claessens and Djankov (1997) document that privatised firms that have been private for four years increase productivity, on average, 3-5 times more than similar firms still owned by the state. In addition, Frydman, Gray, Hessel and Rapaczynski (1999) report that in the early stage of

transition, the performance of both privatised and state-owned firms declines, but privatised firms outperform state-owned ones. Moreover, Claessens and Djankov (2002) find that privatised firms experience greater improvements in annual sales and annual labour productivity growth than state-owned enterprises. In fact, the mean annual sales growth of privatised firms increases by 0.11 percent, but annual sales growth of state-owned enterprises decreases by 0.63 percent. Similarly, annual labour productivity growth of privatised firms increases by 6.24 percent while annual sales growth of state-owned firms increases only by 1.12 percent. Remarkably, privatised firms have a significantly lower rate of labour shedding than state-owned enterprises. For privatised firms the decrease is 6.11 percent while it is 7.42 percent for state-owned enterprises.

2.5.3. Empirical studies examining the effect of ownership structure and corporate governance on firm performance

Since the collapse of the communist political system in 1989, large-scale privatisation programmes have been launched in the transition economies of Central and Eastern Europe and the former Soviet Union. These countries have employed various methods of privatisation, including sales to outsiders (asset sales, share offerings), management-employee buyouts (insider privatisation), leasing and management contracts, and voucher privatisation. Practically, different privatisation methods result in different ownership structures in privatised firms, and in turn they would affect firm performance. To test for the effect of different privatisation methods or ownership structures on performance of newly privatised firms, a number of studies have been undertaken. Some of these studies are briefly summarised in Table 2.4.

First of all, these studies document that concentrated ownership after privatisation generates greater improvements in the performance of firms than diffuse ownership (Weiss and Nikitin, 1998; Claessens and Djankov, 1999a; Dean and Andreyeva, 2001; and Pivovarsky, 2001). Additionally, Weiss and Nikitin (1998) find that ownership concentration through large individual shareholders is associated with improvements in all performance measures, but that concentrated ownership by funds does not improve firm performance. In addition, Pivovarsky (2001) reports that concentrated ownership by foreign companies and banks results in better performance than concentrated domestic ownership. Contrary to these findings, Dean and Andreyeva (2001) argue that concentrated ownership by insiders exhibits the best results in terms of firm performance. Secondly, it is found that foreign ownership is associated with greater performance improvements than entirely domestic ownership (Smith et al., 1997 and Claessens and Djankov, 1999a). Further, Walsh and Whelan (2001) document that firms with majority outside

ownership outperform firms with majority inside ownership or state-owed enterprises. However, Estrin and Rosevear (1999) find that firms with outsider-dominated ownership do not outperform firms with insider-dominated ownership or even state-owed enterprises. Finally, according to Claessens and Djankov (1999b), the appointment of new managers is associated with improvements in profit margins and labour productivity, especially if such managers are appointed by private owners.

To sum up, the impact of privatisation on firm performance has extensively been studied in both developed and developing countries over the last decades. The empirical evidence derived from these studies strongly supports the proposition that privatisation is associated with significant improvements in the financial and operating performance of the firms in question. Specifically, these studies document statistically significant increases in profitability, output (sales), operating efficiency, capital expenditure as well as significant decreases in leverage following privatisation. However, the findings regarding employment are mixed. Indeed, some studies report significant increases in employment and few find insignificant changes while the remaining studies document significant declines in employment. Moreover, the empirical results reveal that ownership structure plays an important role in performance improvements of firms. Specifically, concentration ownership is associated with better performance than diffuse ownership. Additionally, outside ownership is likely to be superior to inside ownership in terms of performance improvement, and foreign ownership, where allowed, performs better than entirely domestic ownership.

2.6. Macroeconomic effects of privatisation

In the literature the macroeconomic impact of privatisation has not been discussed as much as the microeconomic effects (the impact on firm performance). Privatisation has been one policy among a set of measures of structural reform, such as trade liberalisation, deregulation, financial- sector restructuring, and opening-up to foreign direct investment. Therefore, it is very difficult to isolate the effect of privatisation from the effect of other measures. This difficulty explains why the work in this area is limited. The present study focuses on the effect of privatisation on firm performance. However, with the aim of giving an overall picture of the impact of privatisation, this section briefly summarizes the macro-economic effects of privatisation.

Table 2.1: Summary of empirical studies comparing pre and post-privatisation performance of privatised firms

Study	Sample description	Methodology	Main findings
Megginson, Nash, and Randenborgh (1994)	Using data of 61 firms from 18 countries and 32 industries, full or partial privatisation through public share offerings, over the period 1961-1990	Comparing three-year pre- to three-year post-privatisation financial and operating performance Employing profitability, operating efficiency, capital investment, output (real sales), employment, leverage and dividend as the financial and operating performance measures. Testing for the significance of median changes in ratio values between the post- and pre-privatisation period, and for the percentage of firms changing as predicted	Profitability, operating efficiency, real sales, investment spending, dividend payments, and leverage significantly improve following privatisation. Employment also increases after privatisation, but insignificantly
Boubakri and Cosset (1998)	Employing data of 79 newly privatised firms headquartered in 21 developing countries that were privatised over the period 1980 to 1992	Using the same measures and methodology as Megginson, Nash, and Randenborgh (1994)	Profitability, operating efficiency, real sales, investment spending, dividend payments, and employment significantly increase while leverage significantly decreases during the post- privatisation period
D'Souza and Megginson (1999)	Obtaining data of 85 firms in 28 countries and 21 industries that were privatised through public share offerings for the period 1990 to 1996.	Using the same measures and methodology as Megginson, Nash, and Randenborgh (1994)	Profitability, operating efficiency, real sales, dividend payments, and leverage significantly increase during the post-privatisation period. Moreover, capital investments significantly increase in absolute values, but not relative to sales and assets. Finally, employment declines following privatisation, but insignificantly

Table 2.1: Continued

La Porta and López-de-Silanes (1999)	Using data of 218 state-owned companies in 26 different sectors privatised between 1983 and 1991 in Mexico	Comparing post-privatisation financial and operating performance ratios to pre-privatisation ones	Operating income to sales and net income to sales increase by 24.1 and 40.0 percent, respectively, and output (sales) increases by 54.3 percent in comparison with pre-privatisation. In addition, employment significantly declines (by 53.4 percent for blue-collar workers and 53.3 percent for white-collar workers), and operating efficiency, as measured by the average cost per unit, drops by 21.49 percent following privatisation. However, capital investment in fixed assets is mostly unchanged. Further, the improvement in profitability is decomposed into three components: (1) 5 percent is due to higher product prices, (2) 31 percent comes from lay-offs of workers, and 64 percent is induced by productivity gains
D'Souza *et al*. (2001)	Collecting data of 118 firms (from 29 countries and 28 industries), privatised through public share offering for the period between 1961 and 1995	Using the same measures and methodology as Megginson, Nash, and Randenborgh (1994)	Profitability, real sales, operating efficiency and capital expenditure significantly increase, and leverage significantly decreases following privatisation. Moreover, employment increases during the post-privatisation period, but insignificantly. Further, changes in ownership structure significantly contribute to performance improvements, and the level of capital-market development has a positive impact on performance improvements following privatisation.

Table 2.1: Continued

Dewenter and Malatesta (2001)	Obtaining data of 63 firms privatised during the period from 1981 to 1994	Using the same methodology as Megginson, Nash, and Randenborgh (1994) – comparing pre to post-privatisation performance measures	Return on sales and return on assets significantly increase, but return on equity and EBIT-based profitability measures insignificantly decrease after privatisation. Additionally, the study finds that all the measures of leverage significantly decline following privatisation. Finally, the study reports that labour intensity significantly decreases after privatisation
Boubakri and Cosset (2002)	Employing data of 16 newly privatised firms headquartered in Africa during the period from 1989 to 1996	Using the same methodology and performance measures as Megginson, Nash, and Randenborgh (1994) with some exceptions due to unavailable data	Profitability, sales efficiency and real sales increase while the leverage ratios decrease after privatisation, but all changes are statistically insignificant. Moreover, capital investments, measured by capital expenditure on sales and capital expenditure on total assets, significantly increase following privatisation
Harper (2002)	Using data of 453 privatised firms in the first and second waves of Czech privatisation	Using the same methodology as Megginson, Nash, and Randenborgh (1994) Employing a cross–sectional regression to identify the sources of performance changes following privatisation with industry, size, timing, debt, ownership, percent privatised, foreign influence as explanatory variables	Return on sales, net income and sales efficiency significantly increase, but return on assets insignificantly decreases following privatisation. Additionally, real sales and employment significantly decline during the post-privatisation period. Moreover, firms privatised in the second wave perform better that firm privatised in the first wave. Furthermore, small firms show greater improvements than large ones following privatisation. Finally, ownership structure has a small effect on performance improvements of the firms following privatisation

Table 2.1: Continued

Boubakri, Cosset and Guedhami (2004)	Using data of 50 firms from 10 countries in Asia, privatised during the period from 1980 to 1997	Using the same methodology as Megginson, Nash, and Randenborgh (1994)	Privatisation leads to statistically significant improvements in profitability, efficiency and output. Employment also increases, but insignificantly. Further, corporate governance and the economic environment have an effect on the extent of performance improvements. For instance, more developed stock markets and involvement of foreign investors are important determinants of performance changes following privatisation

Table 2.2: Summary of results from five empirical studies into the financial and operating performance of newly privatised firms (compared to their performance as state-owned enterprises)

Measures and studies cited	N	Mean value before privatisation (median)	Mean value after privatisation (median)	Mean change due to privatisation (median)	Z-statistic for difference in medians (after-before)	Percentage of firms with improved performance	Z-statistic for significance of proportion change
1. Profitability (net income ÷ sales)							
Megginson, Nash, and Randenborgh (1994)	55	0.0551 (0.0442)	0.0799 (0.0611)	0.0249 (0.0140)	3.146[a]	69.10	23.064[a]
Boubakri and Cosset (1998)	78	0.0493 (0.0460)	0.1098 (0.0799)	0.0605 (0.0181)	3.155[a]	62.82	2.289[b]
D'Souza and Megginson (1999)	85	0.1400 (0.0500)	0.1700 (0.0800)	0.0300 (0.0300)	3.920[a]	71.00	4.170[a]
D'Souza *et al.* (2001)	119	0.0610 (0.0520)	0.0930 (0.0700)	0.0320 (0.0165)	4.877[a]	70.60	4.440[a]
Boubakri and Cosset (2002)	15	0.1090 (0.0860)	0.1345 (0.0838)	0.0255 (0.0050)	1.022	53.00	0.584
2. Efficiency (real sales per employee)							
Megginson *et al.* (1994)	35	0.9560 (0.9420)	1.0620 (1.0550)	0.1064 (0.1157)	3.66[a]	85.70	6.03[a]
Boubakri and Cosset (1998)	56	0.9224 (0.9056)	1.1703 (1.1265)	0.2479 (0.2414)	4.788[a]	80.35	4.598[a]
D'Souza and Megginson (1999)	63	1.0200 (0.8700)	1.2300 (1.1600)	0.2100 (0.2900)	4.870[a]	79.00	5.760[a]
D'Souza *et al.* (2001)	83	0.9770 (0.9660)	1.0530 (1.0530)	0.0760 (0.0672)	3.398[a]	70.00	3.620[a]
Boubakri and Cosset (2002)	15	0.6613 (0.4118)	0.6422 (0.3665)	-0.0191 (-0.0123)	0.454	47.00	0.670

Table 2.2: Continued

3. Investment							
Megginson *et al.* (1994)	43	0.1169	0.1689	0.0521	2.349[b]	67.40	2.441[b]
		(0.0668)	(0.1221)	(0.0159)			
Boubakri and Cosset (1998)	48	0.1052	0.2375	0.1322	2.277[b]	62.50	1.736[b]
		(0.0649)	(0.1043)	(0.0137)			
D'Souza and Megginson (1999)	69	0.1800	0.1700	-0.0100	- 0.800	55.00	0.850
		(0.1100)	(0.1000)	(-0.0100)			
D'Souza *et al.* (2001)	85	0.9340	1.2920	0.3580	3.361[a]	65.90	3.090[a]
		(0.8260)	(1.0560)	(0.2300)			
Boubakri and Cosset (2002)	12	0.0352	0.2054	0.1702	1.804[c]	67.00	0.795
		(0.0353)	(0.0628)	(0.0390)			
4. Output (real sales)							
Megginson *et al.* (1994)	57	0.899	1.140	0.241	4.767[a]	75.40	4.462[a]
		(0.890)	(1.105)	(0.190)			
Boubakri and Cosset (1998)	78	0.9691	1.2220	0.2530	5.192[a]	75.64	4.578[a]
		(0.9165)	(1.1225)	(0.1892)			
D'Souza and Megginson (1999)	85	0.9300	2.7000	1.7600	7.300[a]	88.00	10.94[a]
		(0.7600)	(1.8600)	(1.1100)			
D'Souza *et al.* (2001)	113	0.9380	1.0940	0.1560	5.286[a]	70.80	4.420[a]
		(0.9240)	(1.0690)	(0.1440)			
Boubakri and Cosset (2002)	15	0.9562	0.9048	-0.0514	0.314	40.00	1.014
		(0.9900)	(0.9853)	(0.0000)			
5. Employment (total employees)							
Megginson *et al.* (1994)	39	40,850	43,200	2,346	0.956	64.10	1.836[c]
		(19,360)	(23,720)	(276)			
Boubakri and Cosset (1998)	57	10,672	10,811	139	1.481[c]	57.89	1.195
		(3,388)	(3,745)	(104)			
D'Souza and Megginson (1999)	66	22,941	22,136	-805	-1.620	64.00	2.310[b]
		(9,876)	(9,106)	(-770)			

Table 2.2: Continued

D'Souza *et al.* (2001)	87	32,570	34,160	1,590	0.751	54.0	0.750
		(12,000	(11,440)	(560)			
Boubakri and Cosset (2002)		-	-	-	-	-	-
		-	-	-			
6. Leverage (total debt ÷ total assets)							
Megginson *et al.* (1994)	53	0.6622	0.6379	-0.0243	-2.408[b]	71.70	3.507[a]
		(0.7039)	(0.6618)	(-0.0234)			
Boubakri and Cosset (1998)	65	0.5495	0.4986	-0.0508	-2.483[b]	63.07	2.108[b]
		(0.5575)	(0.4789)	(-0.0162)			
D'Souza and Megginson (1999)	72	0.2900	0.2300	-0.0600	-3.080[a]	67.00	3.000[a]
		(0.2600)	(0.1800)	(-0.0800)			
D'Souza *et al*. (2001)	104	0.4890	0.4250	-0.0650	4.391[a]	72.10	4.510[a]
		(0.4670)	(0.3820)	(-0.0293)			
Boubakri and Cosset (2002)	15	0.6811	0.6626	-0.0185	-0.738	40.00	1.015
		(0.7430)	(0.7441)	(-0.0029)			
7. Dividends (cash dividends ÷ sales)							
Megginson *et al.* (1994)	39	0.0128	0.0300	0.0172	4.626[a]	89.70	8.179[a]
		(0.00544)	(0.0223)	(0.01213)			
Boubakri and Cosset (1998)	67	0.0284	0.0528	0.0244	4.366[a]	76.11	4.280[a]
		(0.0089)	(0.0305)	(0.0130)			
D'Souza and Megginson (1999)	51	0.0150	0.0400	0.0250	4.975[a]	79.00	5.24[a]
		(0.0000)	(0.0200)	(0.0200)			
D'Souza *et al.* (2001)	-	-	-	-	-	-	-
		-	-	-			
Boubakri and Cosset (2001)	-	-	-	-	-	-	-
		-	-				

[a], [b], [c]: *Significant at the 1%, 5% and 10% levels, respectively.*

Table 2.3: Summary of empirical studies comparing performance of privatised firms to state-owned enterprises

Study	Sample description	Methodology	Main findings
Pohl, Anderson, Claessens and Djankov (1997)	Using data of over 6,300 privatised and state-owned firms in seven Eastern European countries (Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovak Republic, and Slovenia) during the period 1992-1995	Comparing the extent of restructuring across firms	Privatisation has a positive impact on firm restructuring. Firms that have been private for four years have an increase in productivity 3-5 times more than similar state-owned firms
Frydman, Gray, Hessel and Rapaczynski (1999)	Using a sample of 90 state-owned and 128 privatised enterprises in the transition economies of Central Europe (Czech Republic, Hungary, and Poland)	Comparing the performance of privatised firms to state-owned firms, and examining the impact of ownership structure on firm performance Using sales revenues, employment, labour productivity (revenue per employee) and labour and material cost (per unit of revenue) as performance measures of firms	Privatised firms generally outperform state-owned firms, particularly in terms of sales revenue growth. Especially, privatisation has a significantly positive impact on the performance of firms that are controlled by outsiders. However, privatisation has no significant effect on any performance measure of firms that are controlled by inside owners
Claessens and Djankov (2002)	Using data of 3,181 newly privatised and 3,173 state-owned enterprises in seven Eastern European countries (Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia) during the initial transition period from 1992 to 1995	Studying the benefits of privatisation by comparing changes in performance of newly privatised to state-owned enterprises Using sale revenues, labour productivity and employment as the company's performance measures	Privatisation is associated with statistically significant performance improvements of the whole sample, in sales revenues and labour productivity and the rate of labour shedding. Especially, firms that have been private for three years or more significantly outperform state-owned firms, but firms that have been private for less than two years do not significantly differ in performance with state-owned firms

Table 2.4: Summary of empirical studies examining the effect of ownership structure and corporate governance on privatised firms' performance

Study	Sample description	Methodology	Main findings
Smith, Cin, and Vodopivec (1997)	Using a sample of 22,735 Slovene privatised firms during the period from 1989 to 1992	Using the production function to measure effects of foreign and employee ownership on firm performance	Firms with higher revenues, profits and exports are more likely to exhibit foreign ownership and employee ownership. Moreover, an elasticity analysis shows that one percentage point increase in foreign ownership is associated with an increase of about 3.9. percent in value-added, and for employee ownership with an increase of about 1.4%
Weiss and Nikitin (1998)	Using data of 755 Czech firms over the period 1993-1995	Employing both robust and OLS regression techniques	Ownership concentrated by large individual shareholders other than investment funds and companies is associated with positive improvements in all performance measures. However, concentrated ownership by funds does not improve firm performance
Claessens and Djankov (1999a)	Using a sample of 706 Czech privatised firms over the period from 1992 to 1997	Using OLS regression analysis to determine the relationship between ownership structure and firm performance Employing profitability and labour productivity as measures of firm performance	Concentrated ownership is associated with positive changes in both profitability and labour productivity. Specifically, a 10 percent increase in concentration leads to a 2 percent increase in labour productivity and a 3 percent increase in profitability. Moreover, foreign strategic investors and non-bank-sponsored investment funds outperform bank-sponsored funds and local strategic investors

Table 2.4: Continued

Claessens and Djankov (1999b)	Using a sample of 706 Czech privatised firms over the period from 1993 to 1997	Using OLS regression analysis	The appointment of new managers induces improvements in profit margins and labour productivity, especially if the managers are selected by private owners
Estrin and Rosevear (1999)	Using data of 150 enterprises in Ukraine by conducting a survey	Using OLS regression analysis to examine the relationship between firm performance and ownership structure	Private ownership is not associated with performance improvements of firms. Moreover, outsider-owned firms do not perform better than insider- or even state-owned companies
Walsh and Whelan (2001)	Using survey data for 220 privatised manufacturing firms in Bulgaria, Hungary, Slovakia and Slovenia for the period from 1990 to 1996	Employing OLS regression analysis	Firms with majority outsider ownership outperform firms with majority insider ownership or state-owned ones in case the firms inherited CMEA (Council for Mutual Economic Assistance) trade- oriented production from the central planning era. However, for firms inheriting EU trade-oriented production ownership has no impact on firm performance
Dean and Andreyeva (2001)	Using a sample of 190 Ukrainian privatised companies	Using OLS regression analysis	Concentrated ownership has a significantly positive effect on firm performance. Specifically, concentrated insider-owned firms exhibit the best performance
Pivovarsky (2001)	Using data of 376 Ukrainian firms for the year of 1998	Using OLS regression analysis to measure the relationship between ownership concentration and firm performance	Ownership concentration has the positive effect on firm performance. Specifically, ownership concentrated by foreign companies and banks is associated with better performance than domestic owners' ownership concentration.

First, privatisation could improve the financial health of the public sector and reduce the budgetary burden of government subsidies for SOEs. Indeed, it should be expected that more extensive privatisation programmes would lead to lower budget deficits, *ceteris paribus*, because privatisation can raise funds (proceeds from the sales of SOEs) for the government in the short term and eliminate the need for permanent subsidies to state-owned enterprises. Moreover, if firms perform better, the government will not only eliminate subsidies, but also actually start collecting taxes from them. Of course, the impact of privatisation on the public sector will also be determined by the use of the proceeds from privatisation. If the proceeds are used to reduce public debt, which has been the case in the most countries, it would lead to lower interest payments and thus a stronger cash-flow position of the public sector. Consequently, the effect of privatisation on the public sector should be exhibited in lower interest rates, which would foster investment and growth.

Furthermore, privatisation has a significant impact on the development of stock markets. Indeed, privatisation induces an increase in stock-market capitalisation by bringing more commodities to the market. In addition, according to Perotti and Van Oijen (2001), the reduction of political risk through sustained privatisation has a strong effect on stock-market development. Specifically, privatisation has gradually strengthened the institutional framework by forcing a resolution of political and legal uncertainties, which deter stock-market development. The strength of the legal system would increase investor confidence and enhance the development of the stock market.

Finally, although privatisation could have a negative effect on employment in the short-run, it can have a positive effect in the medium and long run. From a theoretical perspective privatisation could reduce the aggregate level of employment in the short-run through the elimination of redundant labour. However, unemployment level could decrease in the medium to long run when the rate of growth of the economy increases as a result of efficiency gains at the micro level and increasing stability at the macro level.

2.7. Conclusion

This chapter provides an overview of the theoretical and empirical literature on privatisation. Privatisation is a broad concept and has been defined in different ways. In general, privatisation is the process of converting ownership of an enterprise from the state to other agents which results in their effective control of the business. In order to transfer ownership of SOEs in such a way, some alternative methods have been used in both developed and developing countries,

including restitution, sales to outsiders, management-employee buyouts, leasing and management contracts, and voucher privatisation.

The theoretical literature reviewed in this chapter helps to shed light on the impact of privatisation, both in terms of its microeconomic and macroeconomic effect. In the microeconomic perspective, on which we concentrate in this chapter, agency theory points out that agency conflicts are the source of the inefficiency of SOEs. Privatisation helps to solve this problem and therefore improves the performance of firms. In a macroeconomic perspective, privatisation has positive effects on the financial health of public sector, the development of the stock market, and employment, especially in the medium and long run. However, some studies still question the benefits of privatisation.

Although theory is not unambiguous, the majority of empirical studies provide evidence that privatisation improves the financial and operating performance of divested firms. Specifically, profitability, output (sales), operating efficiency, and capital expenditure significantly increase, and leverage significantly decreases following privatisation. However, the evidence on the effect on employment is still ambiguous. Indeed, some studies document significant increases in employment and some find insignificant changes while the remaining report significant declines in employment. Furthermore, the evidence derived from empirical studies indicates that ownership structure plays an important role in performance improvements of firms. Specifically, concentration of ownership is associated with better performance than diffuse ownership. Additionally, outside ownership is likely to be superior to inside ownership in term of performance improvements, and foreign ownership outperforms domestic ownership.