Evžen Kočenda

Privatization, Firms and Ownership

Evžen Kočenda
Charles University,
Institute of
Economic Studies.

INTRODUCTION

The purpose of this paper is to summarize key aspects of privatization in former transition economies in Europe and the outcomes that privatization has brought to firms.

The wave of political uprisings in Central and Eastern Europe (CEE) at the end of the 1980s along with the collapse of the former Soviet Union (FSU) led to profound political, economic, and social changes in that part of the world. The demise of the dominating state ownership in the economy was seen as a natural task during the transition from a command economy towards a free market.

In the early 1990s privatization was widely considered one of the keystones of the entire transition process. The policy arguments were primarily based on successful experiences in developed as well as middle-income countries suggesting that privatization improves enterprise efficiency (Megginson and Netter 2001). The so-called Washington Consensus emphasized privatization and the belief that private ownership together with market forces would ensure efficient economic performance. However, it is understandable that privatization alone could not solve all the intricacies of transition, but systemic changes and reforms were needed as well.

Outcomes of privatization in the CEE and FSU countries were studied from both macro and microeconomic perspectives, and the extent of results is voluminous. For that, the key focus of the present assessment is targeted on privatization effects related to performance of firms, their ownership structures, efficiency, and survival. In order to understand the outcomes, a sketch of the privatization setup is presented first.

Privatization

In the CEE and FSU countries, a number of privatization processes took place. These ranged from restitutions and sales of small units to large privatization schemes. Large-scale privatization spawned considerable variation in privatization methods. However, in terms of the extent of privatized assets, mass privatization is the type of privatization that was most important. It is also what most people think of when privatization is discussed. Two key features characterize mass privatization. First, eligible citizens receive (virtually for free) vouchers, which they can exchange in an auction for stocks of privatized firms or privatization funds.[1] As a result, a mass of domestic owners emerges. In contrast to mass privatization, and with some simplification, only three transition countries used predominantly standard methods to privatize state enterprises (mainly) to foreigners: Estonia, East Germany, and Hungary. Second, the privatization is relatively fast. The arguments for fast privatization were that (a) price liberalization and other reforms would not provide sufficient incentives for state firms to restructure and become competitive, (b) the state would not be able to resist intervening in state firms (Frydman and Rapaczynski 1991; Boycko et al. 1995), and (c) managers (and/or workers) would decapitalize firms in the absence of rapid clarification of property rights (Blanchard et al. 1991; Frydman et al. 1993). Both key features brought some unpleasant consequences, though.

Mass privatization has led to ownership structures that were initially highly dispersed because the entire adult population of the country, or all insiders to each firm, were allocated vouchers with which to purchase the shares of the company. Hence, the resulting ownership structure consisting chiefly of domestic owners was more or less an outcome of the logistics of the voucher scheme's administration. More economically meaningful patterns of ownership structure began to emerge only later on. Mass privatization was also argued to hinder the establishment of effective corporate governance, especially when long "agency chains" were created by the emergence of financial intermediaries holding privatization vouchers (Coffee 1996; Stiglitz 2002). Both ownership and governance weaknesses impacted firms' performance, in a broad sense. Gradually, it became recognized that performance is linked with ownership structure, which is even more complex when owners of foreign origin are involved or when formally privatized firms are in reality still controlled by the state.[2]

EFFECTS ON FIRMS

Two decades after privatizations in the CEE and FSU countries, Estrin et al. (2009) assembled a large survey based on extensive literature assessing privatization

[1] An outline of mass privatization using vouchers (i.e., privatization without capital) emerged in 1988 in Poland. Lewandowski (1997, 35) describes that "mass privatization was a unique response to the post-communist challenge. The idea of distributing vouchers to promote equitable popular participation in privatization was elaborated by market-oriented advisers to the Solidarity movement in Gdansk, Poland, in mid-1988. Vouchers were intended to make up for insufficient supply of capital; as a special type of investment currency, they would be allocated to all citizens and tradable for shares of privatized companies. The concept was presented at a conference in November 1988 – when communists were still in power – in response to a solicitation for proposals on how to transform the Polish economy." A description of the method was published by Lewandowski and Szomburg (1990). The voucher scheme was then creatively adopted in several European transition countries.

[2] Specific corporate structures were established by the state as a pragmatic tool to control the economy despite the economy's publicly proclaimed private nature. Evidence of such control is scarce due to the data problems, but it was documented and quantified for example in Russia or the Czech Republic (Chernykh 2008; Kočenda and Hanousek 2012).

effects in individual countries or small groups of countries.[3] Their evidence suggests that privatization and performance are related but that the relationship is more complicated than has been assumed. The type of owner and ownership structure play decisive roles.

One of the findings brought by the large survey of Estrin et al. (2009) is that privatization to foreign owners results in considerably improved performance of firms in the region. Such an effect is best characterized as a fairly rapid shift in performance rather than a gradual improvement. In contrast, the performance effect of privatization to domestic owners in CEE has been positive but smaller and often delayed. There was no or even a negative performance effect of privatization to domestic owners in the FSU. The disparity of findings between the two transition regions coincides with differences in policies and institutional development as the CEE countries were increasingly adopting European Union (EU) rules and joined the EU, while the countries of the FSU proceeded slowly when introducing a market-friendly legal and institutional system.

In terms of ownership structure, the research findings suggest that concentrated (especially foreign) private ownership has a stronger positive effect on performance than dispersed ownership in both CEE and the FSU. This is a key point that has a strong bearing on (a) mass privatization that initially yielded highly dispersed ownership preventing effective control and (b) later changes in ownership structure, often in the form of secondary privatization. In addition, worker ownership in CEE and FSU does not seem to have had a negative effect.[4]

The smaller impact of privatization to domestic rather than foreign private owners can be explained by limited skills and access to world markets on the part of the local managers. Further, domestically owned privatized firms were also the ones where performance-reducing activities such as looting, tunneling, and defrauding of minority shareholders have been most frequent. Finally, in a number of countries the nature of the privatization process initially prevented large domestic private owners from obtaining controlling ownership stakes and insiders or the state often owned sizeable holdings (Kočenda and Hanousek 2008).[5]

With respect to the differences above, Estrin et al. (2009) provide a concise summary of auxiliary measures that improve the chances that the privatization will succeed. Intuitively it is the importance of good management and corporate governance, access to world markets, and the presence of a functioning legal and institutional framework. For the former state-owned firms, restructuring is most easily and effectively achieved by foreign ownership. Foreign firms routinely bring in capable expatriate managers and invest heavily in training local managers. They sell products through their global distributional networks, introduce a relatively advanced system of corporate governance, and stress the importance of business ethics. Corporate governance of foreign firms hence compensates to a considerable extent for the underdeveloped legal and institutional system in many transition economies. While some domestic firms have also developed good corporate governance, the underdeveloped legal system has allowed local managers (or block shareholders) in many privatized firms to maximize their own benefits at the expense of corporate performance and hence welfare of (other) shareholders as well as stakeholders such as workers and the government treasury. This is likely to account for the limited positive performance effects of privatization to domestic private owners as compared to the performance of firms privatized to foreign investors.

FURTHER EVIDENCE

As time passes, the point of privatization is more distant and the future brings changes not only in ownership, but also alterations in the scope and extent of production. Then, it might become harder to disentangle privatization effects properly. Still, large studies employing firm-level data sets are able to provide further evidence about the CEE firms that underwent privatization in the past.

Hanousek et al. (2015) examined more than three million firm/year observations and analyzed corporate efficiency in the EU, accounting for old and new EU countries, as well as pre- and post-crisis periods. While they were not able to specifically differentiate between privatized and non-privatized firms in the new EU, they could distinguish large and medium firms, most of which were privatized in the past. Their key finding shows a strong foreign ownership effect linked to improved firm efficiency. However, the impact is present in firms where a (foreign) majority owner must acknowledge ownership rights of the non-marginal categories of minority shareholders. Such a beneficial effect of foreign owners (subjected to legal or blocking minority control) in new EU countries may be further taken as evidence of corporate governance that gradually improved over time, without doubt, thanks also to inflow of the foreign direct investments (FDI) from old EU countries that overwhelmingly dominate FDI in new EU members.

The above results can be also paired with those of Baumöhl et al. (2019) who analyzed determinants of firm survival in European emerging markets after the financial crisis. Their assessment of firm-specific controls shows that foreign ownership and ownership structure with several shareholders (i.e., less concen-

[3] Earlier, comprehensive, and excellent surveys can be found in Megginson and Netter (2001) and Djankov and Murrell (2002).

[4] The above summary of findings by Estrin et al. (2009) is well echoed in results of Brown et al. (2016) who analyzed effects of privatization on performance of more than 71,000 firms from several CEE and FSU countries. The key outcome is that foreign investors raise post-privatization performance more than domestic owners, and that more concentrated ownership raises privatization effects.

[5] It frequently took these large shareholders several years to squeeze out minority shareholders and, in the process, the large shareholders sometimes artificially decreased the performance of their newly acquired firms in order to squeeze out the minority shareholders at low share prices.

trated control) are the factors with the most significant economic impact on survival probability of large and medium firms in CEE and the FSU.

The overwhelming positive effect of foreign ownership suggests that the participation of foreign owners in the post-privatization process in many CEE countries might bring additional benefits on top of firms' performance alone. For example, in the case of FDI, it has been shown that foreign ownership, through a multinational enterprise (MNE), impacts local firms in a host economy via productivity spillovers (Görg and Strobl 2001). In later evidence, based on a meta-analysis and related chiefly to the CEE countries, Hanousek et al. (2011) document significant spillover effects. Their key result implies that local firms in CEE countries experience efficiency gains if they supply industries with a higher share of foreign firms or if foreign firms sell to them. Further, Hanousek et al. (2017) analyzed the impact of MNEs, via their FDI, on domestic firms in 30 European host economies, before and after the crisis. For the CEE countries, they document the existence of trade (export) spillovers that materialize due to interactions of domestic firms with MNEs.

The above effects are linked to privatization only indirectly. However, since the majority of large and medium firms in CEE and FSU underwent a certain type of privatization, the presented evidence is unlikely to miss the target.

CONCLUSIONS

The main reasons for using mass privatization to the hands of domestic owners were political. As there was an enormous lack of domestic capital, selling the state-owned productive assets to those who were willing to bid the highest price would have meant massive inflows of foreign capital. However, the sale of the firms, which were often presented as "national silver," to foreigners was hardly politically acceptable in early transition and such an approach to privatization was believed to be political suicide for the reformers. The Czech Republic and Russia were the pioneers in implementing the voucher method in mass privatization and throughout the 1990s many transition economies followed these examples in various forms.

However, mass privatization brought dispersed ownership structure, lack of control over management, as well as moral hazard. Lack of capital and inadequate regulatory frameworks at the onset of transition did not help either. Eventually, many privatized firms ended up in bankruptcy or had to be bailed out by the state in order to avoid it. A large number of firms were then re-privatized. At this stage, foreign owners used the opportunity and began changing the ownership landscape in CEE and the FSU. The time lag was considerable, though. Already in the very early 1990s it was evident that mass privatization is unable to immediately deliver functioning ownership structures, but FDI, as a specific privatization instrument, can generate "responsible" owners (Artisien-Maksimenko et al. 1993).

The important lesson from this mass privatization exercise is the fact that privatization as a simple "change of title" does not work. It is true that state ownership of business assets is inherently less efficient than private ownership (Megginson 2016); however, a mere formal privatization does not guarantee improved performance, at least not in the short to medium run. The type of private ownership, corporate governance, access to know-how and markets, and the legal and institutional system profoundly matter for firm restructuring and performance.

Foreign ownership is not a panacea to guarantee a healthy and performing firm either. However, in situations where domestic owners lack money, privatization to foreign owners is a solution. This way privatization brings involvement of private investors in a firm's ownership structure that critically impacts a firm's operating and financial performance (Megginson et al. 1994). On the contrary, giving assets away to anonymous people for a token does not bring a sense of responsibility or capital needed for restructuring. The better way to privatize a firm is to sell it to real people for real money.

REFERENCES

Artisien-Maksimenko, P., M. Rojec, and M. Svetlicic, eds. (1993), *Foreign Investment and Privatization in Eastern Europe,* Palgrave Macmillan, UK.

Baumöhl, E., I. Iwasaki, and E. Kočenda (2019), "Institutions and Determinants of Firm Survival in European Emerging Markets", *Journal of Corporate Finance* 58, 431-53.

Blanchard, O., R. Dornbusch, P. Krugman, R. Layard, and L. Summers (1991), *Reform in Eastern Europe*, MIT Press, Cambridge, MA.

Boycko, M., A. Shleifer, and R. Vishny (1995), *Privatizing Russia,* MIT Press, Cambridge, MA.

Brown, D. J., J. S. Earle, and A. Telegdy (2016), "Where Does Privatization Work? Understanding the Heterogeneity in Estimated Firm Performance Effects", *Journal of Corporate Finance* 41, 329-62.

Chernykh, L. (2008), "Ultimate ownership and control in Russia", *Journal of Financial Economics 88* (1), 169–92.

Coffee, J.C. (1996), "Institutional Investors in Transitional Economies: Lessons from the Czech Experience" in: R. Frydman, C. Gray, and A. Rapaczynski, eds., Corporate Governance in Central Europe and Russia, Vol. 1, *Banks, Funds, and Foreign Investors*, CEU Press, Budapest, 111-86.

Djankov, S. and P. Murrell (2002), "Enterprise Restructuring in Transition: A Quantitative Survey", *Journal of Economic Literature* 40 (3), 739–92.

Estrin, S., J. Hanousek, E. Kočenda, and J. Svejnar (2009), "The Effects of Privatization and Ownership in Transition Economies", *Journal of Economic Literature* 47, 699-728.

Frydman, R., E. S. Phelps, A. Rapaczynski, and A. Shleifer (1993), "Needed Mechanisms of Corporate Governance and Finance in Eastern Europe*", Economics of Transition* 1 (2), 171-207.

Frydman, R. and A. Rapaczynski (1991), "Markets and Institutions in Large Scale Privatization: An Approach to Economic and Social Transformation in Eastern Europe", in V. Corbo, F. Coricelli, and J. Bossak eds., *Reforming Central and Eastern European Economics; Initial Results and Challenges*, The World Bank, Washington, D.C., 253-74.

Holger, G. and E. Strobl (2001), "Multinational Companies and Productivity Spillovers: A Meta-analysis with a Test for Publication Bias", *Economic Journal* 111, 723-39.

Hanousek, J. and E. Kočenda (2008), "Potential of the State to Control Privatized Firms", *Economic Change and Restructuring 41, 167-86.*

Hanousek, J., E. Kočenda, and M. Maurel (2011), "Direct and Indirect Effects of FDI in Emerging European Markets: A Survey and Meta-analysis", *Economic Systems* 35, 301-22.

Hanousek, J., E. Kočenda, and A. Shamshur (2015), "Corporate Efficiency in Europe", *Journal of Corporate Finance* 32, 24-40.

Hanousek, J., E. Kočenda, and P. Vozárová (2017), *Effects of Export Spillovers, FDI, and Ownership Structures on Firms' Performance*, CEPR DP 12124.

Lewandowski, J. (1997), "The Political Context of Mass Privatization in Poland", in I.W. Lieberman, S. Nestor, and R.M. Desai, eds., *Between State and Market: Mass Privatization in Transition Economies, Studies of Economies in Transformation no. 23, The World Bank, Washington, D.C., 35-39.*

Lewandowski, J. and J. Szomburg (1990), "Dekalog prywatyzacji", Tygodnik Solidarność, No. 45 (Supplement).

Megginson, W.L. and J. Netter (2001), "From State to Market: A Survey of Empirical Studies on Privatization", *Journal of Economic Literature* 39 (2), 321-89.

Megginson, W. L. (2016), "Privatization, State Capitalism, and State Ownership of Business in the 21st Century", *Foundations and Trends in Finance* 10 (3-4), 181-362.

Stiglitz, J. (2002), *Globalization and its Discontent*s, Norton, New York.