Is Privatisation Good or Bad? Assessing the Effects

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In October 2013 the British Government privatised Royal Mail, one of the oldest state-owned enterprises (SOEs) in Europe. Privatisation was done through flotation on the stock exchange, with employees obtaining 10 percent of the shares free of charge. The privatisation was a great success as far as demand for shares was concerned: investors oversubscribed for the shares and the government ended up selling more than it initially intended. But was it a good idea to sell this company? More generally, what are the pros and cons for privatisation (and so for keeping or not keeping enterprises under state ownership)? And what do data tell us about the actual benefits and risks of privatisation? This column discusses the reasons why governments want to privatise the companies they directly control, what are the fears associated with privatisation, and what researchers found about the effects of privatisation on firm behaviour.

Why governments privatise?

The main reason for privatizing SOEs is the depolitisation of firms. Politicians – as all of us, humans – respond to incentives which may not coincide with the profit maximization of enterprises. They may be less inclined to put time and energy in controlling firms than private investors, as they do not have their wealth vested in the company, nor can they reap the monetary gains of high profits. Not only are they not motivated to efficiently control the enterprise, but their incentives may actually be distorted as they can use SOEs in ways which meet their personal interests. The likelihood or re-election, for example, depends on the employment opportunities and wages of voters – if the politician overstaffs SOEs and gives workers high wages, they will be more willing to vote for the incumbent party. Lower prices of the output can also be viewed by voters as beneficial and thus may turn them to support the government in office. While these actions can also socially beneficial (albeit costly and putting extra burden on the State budget), SOEs can also be used more directly to pursue personal goals. Well paid jobs can be given to persons supporting the ruling party and outright corruption (through advantageous procurement contracts or sales of the output at a low price made with supporters or friends) may benefit politicians or their friends.

The political or personal benefits come at a price, however. First and perhaps most important, the loose control, vote maximization and corruption lead to inefficiencies and high costs. These extra costs make the firm less profitable or even loss-making which would require subsidizing the firm from the scarce funds of the State's or the Local Administrations' budget. The money spent on SOEs, of course, puts a burden on the budget since the subsidies (or low tax revenues) take away funds from other items or new income has to be generated

(through higher taxes, for example). These measures are never popular so the potential political gains of running state-owned enterprises may vanish, giving room for to privatisation. In addition, state ownership and corruption are many times intimately linked which can also be viewed negatively by politicians not involved in the activities of SOEs. Finally, privatisation can create income for the state's budget through the sale price of the enterprise and also through higher tax revenues if the company is turned around and becomes more efficient under private ownership.

Why then governments still oppose privatisation? Besides the obvious fact the politicians, who benefit from directly controlling these firms, will lobby for keeping firms under state ownership, other organizations – predominantly unions – are also against the sale of SOEs. The reason for this is the widely shared belief that the beneficial effects of privatisation materialized in higher levels of efficiency will be achieved through cost reduction, which will result in layoffs and lower wages. Such fears that the beneficial performance effects of privatisation are gained on the expense of the workers will also make politicians reluctant to engage in privatisation. This logic, however, misses another potential positive effect of privatisation: if the new private owners not only engage actively in cost reduction, but also increase the scale of production by being more entrepreneurial than state bureaucrats were and more successful in finding new markets, this scale effect can offset the negative employment effect of cost reduction. Wages may also increase if the company wants to motivate employees to work hard and do not leave the company.

Privatisation – as well as state ownership – is often accused of corruption and favouritism (and by inefficient regulation), but privatisation is a one-time event: the state detaches from the company and in the future it cannot directly interfere in its activity. This is much better than state ownership of enterprises when politicians can continuously affect the companies' daily business decisions.

Measuring the effects of privatisation [THIS SECTION CAN GO INTO A BOX]

Studying with real-world data how firm behaviour changes when the firm is privatised is therefore important to understand whether the expected benefits and fears of privatisation are indeed accurate: does privatisation actually lead to higher firm efficiency? Does it indeed harm workers through lower employment levels and wages?

Perhaps the best laboratory of studying such questions is the Central and East-European (CEE) region, when not only a few enterprises were under state ownership as in developed countries, but during state socialism practically every firm was. When these

countries freed up from the command economy, privatisation was among the major policies which changed the old socialist system. SOEs were of all sizes and belonged to all kinds of industries. Privatisation studies based on such data were therefore able to use large samples of both state-owned and privatised firms, long time series, and both state- and privately owned firms in the same industry, all necessary to make good statistical analysis. If there are no state-owned and privatised firms within the same industry, industrial effects (e.g., different industrial productivity or wages) can be confounded with privatisation effects. Also, it will be impossible to differentiate between time effects and a genuine privatisation effect. Let's take the following example: if the timing of privatisation coincides with a recession, simply measuring the change of some firm variable before and after privatisation may pick up the effect of the recession as well. To overcome this problem, some studies measure the effect of privatisation *relative to* the evolution of not privatised SOEs: that is, the difference in performance, employment and wages between privatised and state-owned companies.

Finally, *selection* of firms into privatisation can also make results unreliable. If the new private owners select the more efficient firms and leave in state ownership the bad ones, the researcher may confound this selection effect with a genuine privatisation effect. With statistical methods, one can control, at least partially, for this unobserved selection effect and the results discussed in this article do take into account these potential selection problems.

The effect of privatisation on firm performance

The effect of privatisation in four CEE countries is presented in this section, which all underwent major privatisation programs in the nineties, changing the ownership of tens of thousands of state-owned enterprises. The countries are Hungary, Romania, Russia and Ukraine and the firms cover all the sectors of the economy except in Russia when the data are available only for manufacturing. The effects of privatisation are presented separately for privatisation takeovers from domestic and foreign entities, as there are reasons to believe that these alter firm behaviour in various ways. Foreign owners may have more expertize of running companies in market conditions, they may possess new technologies and have access to funding.

Figure 1 presents the effect of domestic privatisation on three performance indicators: return on sales (ROS), defined as the company's net income of sales, labour productivity (LP, equal to the value of real sales over employment) and the volume of sales. The bars show the estimated privatisation effect. The line segments within the bars show the 99-percent confidence interval of the coefficients: if this segment crosses the horizontal axis, the

estimated effect cannot be distinguished from zero in statistical terms so privatised firms behave similarly as SOEs which were not privatised. Both ROS and LP increase after privatisation, and the effects are quite large: ROS increases by 2 percentage points in Russia and Ukraine, by 4 percentage points in Hungary and by 12 percentage points in Romania. The next performance indicator, LP also increases the most for Romania (by 28 percent), followed by Hungary (11 percent). For Ukraine the effect is also quite large and positive (6 percent), but in Russia the analysis shows a negative effect of 6 percent. This means that Russian privatised firms decreased their productivity relative to firms which remained in state ownership! Finally, the volume of sales are increased by privatisation to domestic owners only in Hungary and Romania (by 16 and 32 percent) while in the other two countries they decline by 5-7 percent.

The effects of takeovers by foreign firms or individuals (presented in Figure 2) are more similar across countries as all the three performance variables unambiguously increase after the privatisation and the effects are much larger than those measured for domestic privatisation.

The effects of privatisation on employment and wages

We saw that privatisation has a positive effect on firm performance in three out of four countries, but what about the workers? Is the efficiency increase earned at the expense of employment and wages? Figure 3 shows the employment effect of privatisation and finds that domestic privatisation had positive effects only in Hungary where it induced an employment size increase of 5 percent. In Romania and Russia this variable is not affected by privatisation while in Ukraine employment falls by 19 percent. The figure also shows the employment effects on the sample of foreign privatisation: these effects are all positive and large in magnitude as employment increases in these firms by 16-45 percent.

Finally let's look at the evolution of wages in privatised firms (these result pertain only to Hungary as data on workers and firms was available only for this country). Domestic privatisation decreased workers' wages by 9 percent while the opposite happened in foreign-privatised companies: here wages increased by almost 12 percent. Privatisation, therefore, induces some substantial wage dispersion as domestically privatised firms' employees suffer from wage reductions while those employees who are employed by foreign-privatised firms enjoy a wage increase. But the story does not end here. The wage effect may be different for various worker groups and indeed this is the case. As shown in Figure 4, domestic privatisation had negative effects on the wages of all occupations' but the magnitude of the

decline varies quite substantially. Professionals, associate professionals and clerks experienced a wage penalty of 3.5-5.5 percent, managers of 7 percent (which is not different from zero in statistical terms). Unskilled manual workers had a wage decline of 6 percent while service and skilled manual workers were the most badly hit by privatisation, experiencing wage declines of 10 and 13 percent, respectively.

The wage effects of foreign privatisation were also diverse among workers, as Figure 5 shows. The highest wage premium was received by managers, who enjoyed a 35 percent wage increase after privatisation. Professionals also had a wage increase of 25 percent. Associate professionals and unskilled workers got similar premia of 10 percent while clerks also got 7 percent. The least fortunate workers are the skilled manual workers with only a 3 percent wage increase and service workers, whose wages did not change.

Is then privatisation good or bad?

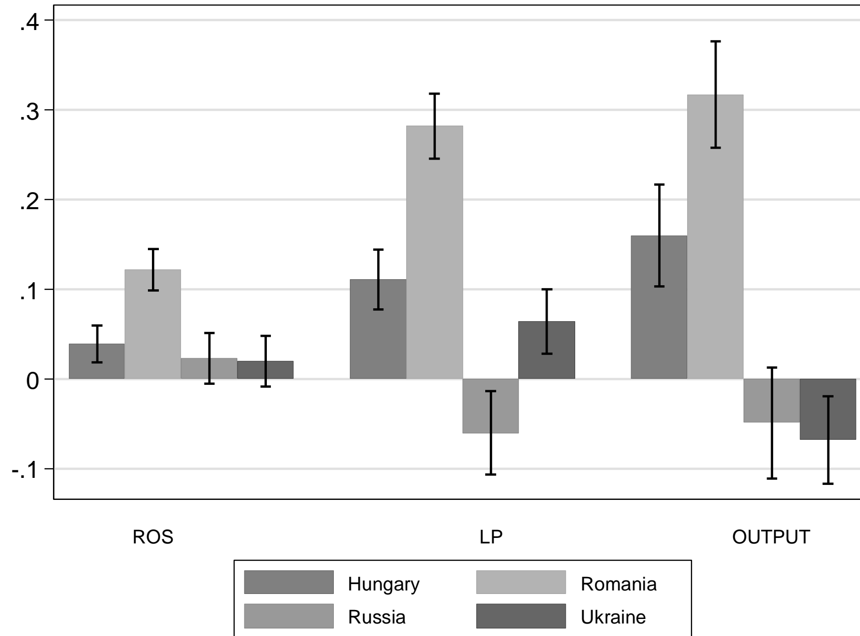
These results show, therefore, that in three out of four countries domestic privatisation unambiguously fulfilled its main role and increased both financial and operating efficiency. In two countries this was also accompanied with the increase of the volume of sales. The employment effect of privatisation is positive in one country, zero in two, and negative in only one country. The wage effects are negative in Hungary but for most worker types they induce a relatively small decline of about 5 percent. Foreign takeovers of Central and East European SOEs are real success stories as they raise efficiency, the volume of sales and also employment and wages. To summarize, this research did not identify very large negative effects on workers (except for the wages of some groups) and at the same time it found that privatisation fulfils its main role and mostly increases firm efficiency.

Review notes

- The main goal of privatisation is the depolitisation of firms, which will lead to increased firm performance. The fears of politicians' and policy makers associated with privatisation concern negative effects on employment and wages;
- The analysis finds that both the financial and operating performance of firms increases after domestic privatisation with the sole exception of Russian operating performance;
- The analysis cannot uncover large negative employment effects of domestic privatisation. Wages fall after privatisation, but for most occupations the drop is under 5 percent.
- Foreign privatisation leads to massive firm performance, employment, and wage increase.

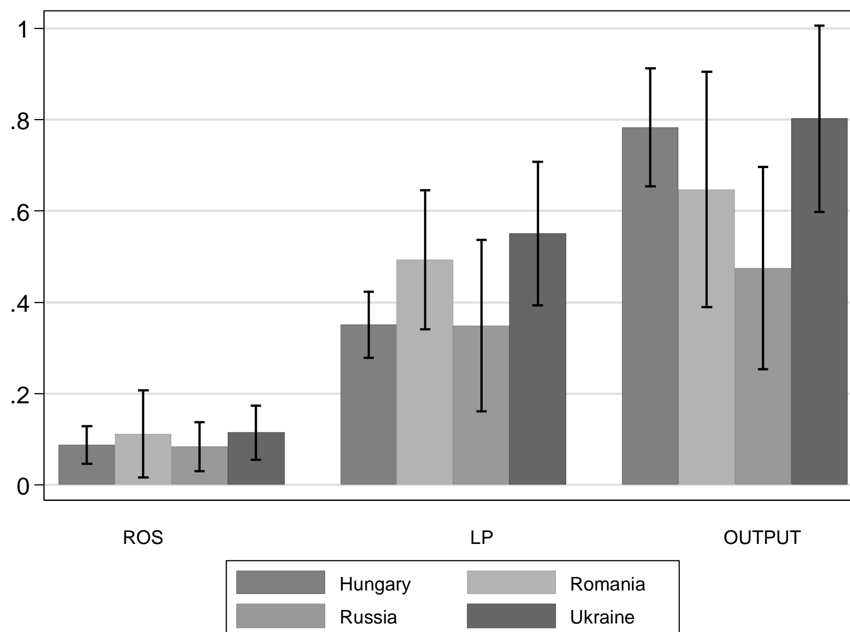
Figures

Figure 1. Domestic Privatisation Effects on Firm Performance



Source: author's own calculation.

Figure 2. Foreign Privatisation Effects on Firm Performance



Source: author's own calculation.

Figure 3. Employment Effects of Privatisation

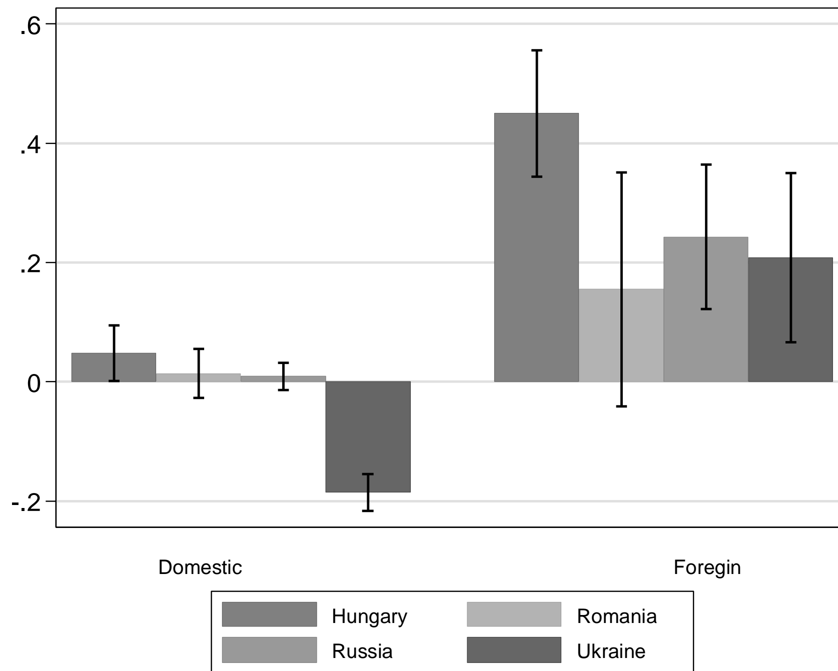
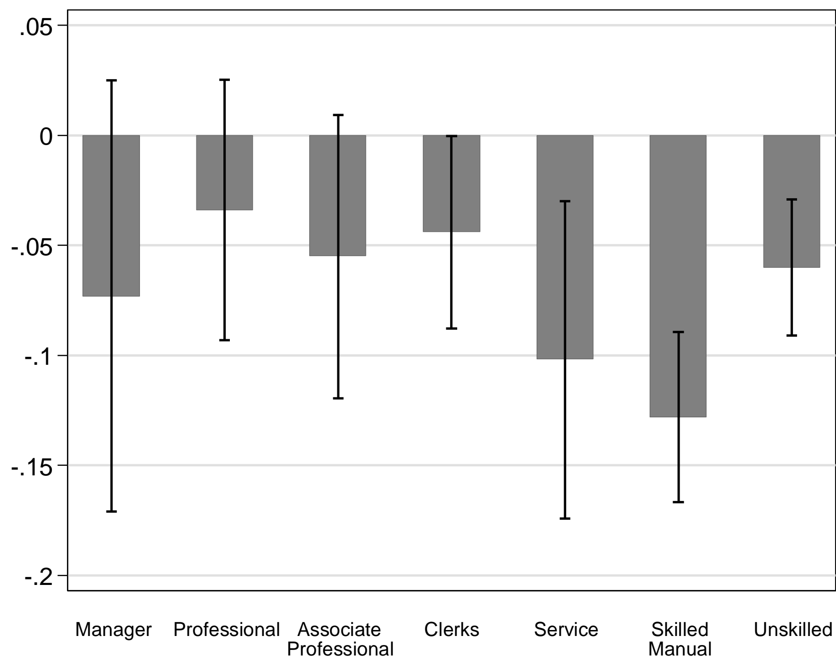
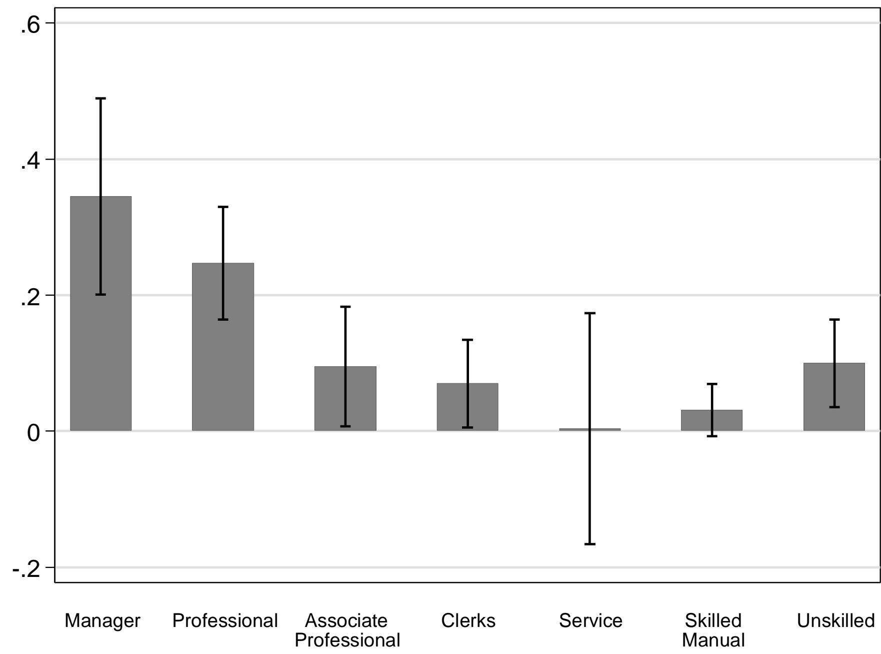


Figure 4: Wage Effects of Domestic Privatisation in Hungary



Source: Earle and Telegdy (2012).

Figure 5: Wage Effects of Foreign Privatisation in Hungary



Source: Earle and Telegdy (2012).