EXPLORING THE LINK BETWEEN PRIVATIZATION AND OTHER POLICIES IN TRANSITION

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1.

Privatization policies in transition economies are getting mixed evaluation. It appears indeed that privatization itself is not enough to make firms perform well. One of the important lessons of transition is that strong complementarities exist between various policies or reform measures. This concerns notably privatization. Privatization alone is not enough to ensure economic development and growth. It certainly requires financial and monetary stability and control; it also needs appropriate institutional framework. Simon Johnson and Andrei Shleifer argue that the effectiveness of privatization is greater when corporate governance works well. And corporate governance works well, and this is the main point of the paper, when the legal system ensures the protection of investors. Specific form of corporate governance does not seem to really matter, what matters is legal protection. If the legal system is weak (as it usually is, according to the authors, in civil law countries), there is still hope because strong regulatory framework can compensate for this weakness and ensure the protection of outside investors. In this context, Poland is presented as a model of efficient regulatory policy where modern, American type regulations of the stock market were beneficial for the development of the financial system and, consequently, for the privatization of state-owned enterprises.

I do not want to question the importance of the legal system. It is clear that the quality of the legal system, and, more generally, the quality of institutions and regulatory environment, may help explaining cross-country differences in performance. I am not sure, however, that transition countries are good sample for testing, for instance, the view that legal origin has persistent impact on development. Most countries have a civil-law tradition and those that are in the process of European Union accession are adopting civil-law type institutions. So the origin of the law can hardly explain the differences in investors' protection. Another problem with the studies presented by Simon Johnson is their inherently cross-sectional dimension. What this literature shows is a correlation between the quality of the law and financial development. In order to show a causality effect we would need panel data allowing to test the relationship between institutions and performance in a dynamic framework. The lack of such data strongly weakens the robustness of the results.

But even if we were able to explain cross-country differences in performance, an important puzzle of transition remains great heterogeneity in firm performance within countries and even within industries. Differences in firm performance within the same industry cannot be explained by the quality of legal environment. Corporate governance could still provide some explanation of firms' successes and failures but other characteristics than the quality of the law on the books or law enforcement should play a role. Let me comment on this.

2.

The first such characteristic could be the ownership structure. Looking at the way the problem of corporate governance has been treated in the process of transition, it appears indeed that the main concern was the separation of ownership and control and the conflict between managers and shareholders. Therefore the main objective was to ensure the control of shareholders on the management. In such perspective mass privatization, distributing assets to the population was usually blamed as inefficient because of the dispersed ownership structure it was supposed to create. In Poland, the idea that the effect of privatization will depend upon the quality of the ownership structure was implicitly present in the design of the privatization strategy. The main objective was to find a 'real' owner, somebody willing to and capable of enforcing control over management. Special programs have been designed with the objective of putting in place a concentrated ownership structure providing adequate incentives and tools for monitoring. In particular, the program of National Investment Funds was conceived in order to avoid the dispersion of control rights which might result from the transfer of several hundreds of firms to the population. The design of this program was dominated by the concern about firm restructuring and corporate governance. Consequently, a concentrated ownership structure was imposed on the firms and the funds were to be managed by highly experienced western specialists.

In the Czech Republic, such concern was practically absent from the design of the privatization strategy. Privatization was understood as the precondition for the process of radical institutional change and was supposed to generate important spillover effects. Consequently, the main concern was the speed of the process and less attention was paid to the emerging ownership structure.

3.

According to the classical view the objective of corporate governance should be to maximize shareholders' value. Recently, however, it has been suggested that a broader definition of corporate governance should be adopted. Instead of being considered as an institutional device dealing with the potential conflict of interest between shareholders and managers, it should take into account the welfare of all parties having an interest and long term relationship with the enterprise: employees, customers, suppliers (cf. Tirole, 1999; Stiglitz, 1999; Berglöf and von Tadden, 2000; Allen and Gale, 2001). Sometimes it is even argued that a firm should not only be responsible for the protection of those who have a contractual relationship with the firm but also, in a even larger perspective, that it should behave in an 'ethical' way, i.e. refraining from bribing officials or from polluting. This is the idea of a stakeholder society. [1]

Privatization policies in most transition countries have implicitly recognized the need to broaden the focus of corporate governance and have taken into account the interests of insiders giving them equity holdings in their firms. So insiders have become shareholders. Focusing on shareholder value, even if we recognize the arguments in favor of stakeholders society, may indeed appear as a second best solution. It would be extremely difficult to devise an incentive scheme for managers allowing taking into account various stakeholders' interests. Tirole (1999) argue in particular, that if managers had to maximize the sum of various stakeholders' interests, they should also be rewarded on the basis of some measure of aggregate welfare of all stakeholders. Such measure, an equivalent of the stock market value of assets, is not easy to be found. Eventually, managers left with and arbitrating between contradictory objectives would be able to capture important rents.

4.

So let us come back to the importance of the ownership structure. Twelve years after the beginning of transition there is some empirical evidence, which help us re-assessing the initial concern about

[1] The main argument for such a view is the change in the theory of the firm. According to an older view, tangible assets were considered as critical resources of the firm. Human capital was tied to the inanimate assets. Legal claims, or the ownership of assets, were considered as the most important source of power. Each contract had a pre-determined payoff, except the one of shareholders. The latter, having comparative advantage in diversifying risk, accept a residual payoff. Therefore, the maximization of shareholders' value led to maximization of the value of the enterprise.

According to the new view of the firm, the role of human capital relative to inanimate tangible assets has strongly increased. The firm cannot be defined anymore by the common ownership of assets. The boundaries of economic organizations have become less well defined. Knowledge, not tangible assets, has become the main source of economic advantage. This suggests that the focus of corporate governance must shift. It should study mechanisms that give the firm the power to provide incentives to human capital. What are the consequences of this change for corporate governance? If all contracts are incomplete, all stakeholders can be at some time residual claimants. Then maximization of shareholders' value does not necessarily lead to maximization of enterprise value (Tirole, 1999) the dispersed ownership in a new light. From our joint research program undertaken with the CASE Foundation we know, for instance, that the ownership structure in the firms privatized through various schemes of mass privatization has undergone profound changes. In the Czech Republic, starting from a highly dispersed ownership structure, the large majority of companies have found a dominant owner. In Poland, starting from a uniform ownership structure imposed by the mass privatization program, the majority of companies involved in the scheme have also found dominant owners, some 10% of them being foreign investors. So the deliberate search for 'good' ownership structure notwithstanding, the ownership structure evolved in response to various pressures and constraints characterizing firms' environment. This is really what the spiritual fathers of the mass privatization schemes expected. The conditions for the evolution of ownership were, of course, not the same in the two countries. The differences in the regulatory framework, and notably the lack of any Securities and Exchange Commission in the Czech Republic, created very different conditions for the reallocation of property rights. But it should be underlined that the extent of ownership concentration in the two countries was quite similar. This result is striking if we consider, following Simon Johnson and Andrei Shleifer, that concentration of ownership is a response to the poor legal framework and low level of protection of minority investors. Given important differences in the shareholder protection between Poland and the Czech Republic we should observe higher ownership concentration in the Czech firms than in the Polish firms.

5.

It is not obvious, however, that concentrated ownership structure has positive impact on firm performance. Until recently the literature on governance issues has been dominated by the early concern of Berle and Means who stressed the negative consequences of the dispersed equity holdings. The separation of ownership and control and the agency problem between shareholders and managers was viewed as the main impediment to the provision of external finance to firms. Concentration of ownership stakes has long been considered as a potential solution to this problem.[2] However, recent theoretical literature suggests that ownership

[2] Managerial equity ownership is often viewed as another way of alleviating agency costs within the firm (Jensen and Meckling, 1976). But this relationship between internal managerial share ownership (and employee ownership) and performance may be ambiguous. Managerial share ownership may also increase managerial opportunism, lead to entrenchment and allow the manager to pursue other aims than profit-maximization with having the advantage of some protection against hostile takeover, or simply hostile decisions by the board of directors (see Stulz (1988). Some empirical evidence suggests that there exists a non-linear relationship between managerial shareholdings and firm value: low levels of shareholdings may increase the convergence of interest and increase firm value, but beyond some threshold management becomes entrenched and the firm value may decline. (see for instance Morck, Shleifer and Vishny (1988).

concentration may have an ambiguous impact on firm performance. First, concentrated ownership is costly for large shareholders because it limits diversification and reduces the owners' tolerance towards risk (Demsetz and Lehn, 1985, Heinrich, 2000), which may affect investment decisions. Second, controlling shareholders may be responsible for the expropriation of minority shareholders (La Porta et al., 1998). Third, concentrated ownership can provide incentives to control the management, but it also reduces the manager's initiative or incentives to acquire information (Aghion and Tirole, 1997). In this perspective, Burkart et al. (1997) view the dispersed ownership as a commitment device ensuring that shareholders will not exercise excessive control, which might hinder managerial activism. It is clear, that in the context of transition characterized by high degree of uncertainty about what should be produced and how, the competence of those who manage and control the firm, and their initiative, may turn out to be the most important determining factor of success. If we accept that there is a trade off between monitoring and initiative, leaving some degree of control in the hands of managers may be desirable. Consequently, when managerial initiative and competence is particularly valuable (which may occur when firms face high uncertainty), a concentrated ownership may be harmful. Fourth, dispersed ownership implies higher stocks' liquidity, which, in turn, improves the informational role of the stock market (Holmström and Tirole, 1993). The generation of information by the stock market is particularly valuable in an uncertain environment (Allen, 1993), or when it is essential to ensure that the management of underperforming firms changes hands. Overall, in some circumstances, that we can roughly described by high degree of uncertainty, separation of ownership and control may turn out to be optimal for shareholders. (cf. Allen and Gale, 2000). On the other hand it is important that ownership dispersion does not preclude the formation of control blocks when needed (cf. Bolton and von Thadden, 1998). So, there seems to be no clear-cut theoretical prediction of the relationship between ownership structure and performance.

6.

Scarce empirical evidence shows that ownership concentration has a non-linear effect on firm performance. In some circumstances firms with more dispersed ownership stakes perform better than firms with more concentrated ownership. However, absolute control with more than 50 percent of voting rights seem to be associated with better performing firms. Trying to explore the relationship between ownership concentration and firm performance we analyzed the firms listed on the Warsaw Stock Exchange (cf. Grosfeld and Tressel, 2001). We found a U-shaped relationship: firms with relatively dispersed and relatively concentrated ownership have higher productivity growth than firms with an intermediate level of ownership concentration. This correlation between concentration of ownership and productivity growth is not explained by the identity of controlling shareholders.

We have also looked at the relationship between product market competition and corporate governance. How do they interact when affecting firm productivity? Do corporate governance and competition reinforce each other (are complementary) or should they rather be considered as a substitute to another. If they were complements, the impact of product market competition would be greater in firms with efficient governance structure. Identifying a joint effect of competition and corporate governance may have important policy implications.

Our results strongly support the idea that good ownership structure and competitive pressures are complements rather than substitutes. Competition has no significant impact on productivity growth in firms with 'poor' governance; it has a significant and positive effect in the case of firms with 'good' corporate governance. So, competitive pressure in Poland did not compensate for the weakness of corporate governance mechanisms. Competition and corporate governance are complements, not substitutes.

7.

So, what really matters? Given the ambiguous impact of ownership concentration on firm performance it appears that the important factor determining the success or failure of transition economies is less specific corporate ownership structure than the possibility for the firm to adjust its corporate governance arrangements in response to its specific needs, pressure of the environment, etc. Therefore, the important question may be less the quality of the law but the possibility of flexible adaptation of institutional constraints which should not create obstacles to the emergence of appropriate corporate governance arrangements.

The last point concerns the relative importance of the law and of the enforcement of the law. Looking carefully at this issue Pistor et al. found that the effectiveness of legal institutions has a much stronger impact on the development of financial markets than the quality of the law on the books. The question would then be what makes law enforceable. Here, again, we should go back to the key factor which seems having significantly influenced the success of reforms: the credibility of the government commitment to protect the functioning of the market.

8.

Coming back to the paper presented by Simon Johnson, let me make one general comment concerning the underlying view of the process of institutional change. The paper that has been presented takes the law as something that stands apart from the market and is treated separately. In other words it suggests that governments should take care of the legal infrastructure in order to make a market economy function properly. Such an approach was advocated among others by Joseph Stiglitz and questioned, several years ago, by Andrei Shleifer and his co-authors. Stiglitz argued that privatization should be implemented after the whole legal and regulatory framework is in place. What was important, according to Stiglitz, was not privatization as such but rather competition and a set of credible and enforceable laws and regulations. On the other hand, for Andrei Shleifer institutions should be considered in relation with the privatization process. He argued that "institutions will follow private property rather than the other way round" and "institutions supporting corporate governance…are developing rapidly in part because of profit opportunities made available by the privatized firms". So privatization was not only supposed to bring about improvement in managerial incentives. It was also viewed as a precondition allowing triggering the process of institutional change. In such perspective law and regulations appear as to some extent endogenous to the privatization process. This was an important point of disagreement. The question is whether the experience of the last twelve years can illuminate this controversy.