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# Privatization, State Capitalism, and State Ownership of Business in the 21<sup>st</sup> Century

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# Privatization, State Capitalism, and State Ownership of Business in the 21<sup>st</sup> Century

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## ABSTRACT

This study summarizes the economic and political developments relating to privatization, state capitalism, and state ownership of business since 2000 and then surveys the extensive recent research examining these issues empirically. Through the early 21<sup>st</sup> century, there was an unambiguous global trend towards reducing government ownership of business enterprise, but this trend has since at least been slowed, and perhaps even reversed. We discuss the factors that have promoted a global resurgence of state ownership, then define and analyze the new ideology labeled “state capitalism.” Recent research examines whether privatization improves the operating and financial performance of divested companies, as well as when, where and how governments decide to privatize individual companies and how these sales are priced. All the performance studies surveyed document significant improvements after companies are divested. Recent academic and professional research categorizes and evaluates various types of state owners; examines determinants of the level of state ownership; studies how state ownership impacts the valuation of corporate assets and examines the relative

efficiency of state versus private ownership; and assesses how state ownership impacts corporate financial policies, especially capital investment. This research highlights that different types of state owners have very different impacts on corporate value and performance, and that state ownership generally has a significant, and mostly pernicious, impact on corporate investment and financial policies. The separate effect of state ownership on corporate valuation is less clear-cut. This survey also summarizes recent empirical research examining the relationship between state ownership of business assets and financial markets and institutions, and also surveys the literature examining political connections between politicians and corporate managers. Sovereign wealth fund research yields essentially benign findings, but almost all studies examining state-owned banking show that state ownership reduces banks' efficiency. All the financial markets and institutions studies examined highlight the distortive effects and economic costs of bailouts and guarantees, and almost all the political connections studies find that these connections are privately beneficial but socially costly. Finally, the research surveyed here convinces the author that "state capitalism" is an essentially failed model.

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# 1

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## Introduction and Overview

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Half-way through the second decade of the twenty-first century, is State involvement increasing or decreasing in the business affairs of the world? At the start of this millennium, it appeared that an ongoing wave of privatizations and market-oriented reforms worldwide was steadily reducing the sway of government over business activity, and particularly the direct state ownership of business enterprises. Then the world appeared to change: the economic rise of a China dominated by state-owned enterprises, the seemingly inexorable rise in global oil prices fueled by national oil companies wholly-owned by non-democratic countries, and the re-emergence of autocratic states (Russia, Iran, Venezuela) rife with cronyism all seemed to point to a world heading towards State Capitalism, where governments sometimes owned but always promoted the interest of national champions in key industries, discouraged inward foreign direct investment, and restricted competition. So which view is correct? Is the state's role in global business increasing or decreasing, and what does this portend for global welfare?

This article will provide an overview of economic and political developments relating to privatization, state capitalism, and state ownership of business, and will then survey the extensive recent research examining privatization and state ownership. As a general rule, I will not cite

work produced earlier than 2005, since this literature has already been surveyed in Megginson and Netter (2001); Gupta *et al.* (2001); Shirley and Walsh (2001); Djankov and Murrell (2002); and Megginson (2005), among others. Similarly, I will not generally re-cite articles discussed in survey articles on privatization in transition economies (Estrin *et al.*, 2009); state-ownership and privatization of banking worldwide (Megginson, 2005); the impact of privatization on global capital markets (Megginson, 2010); the rise of sovereign wealth funds as international investors (Megginson and Fotak, 2015; Gao *et al.*, 2017); the relative efficiency of state versus private provision of health care services (Mühlenkamp, 2013); or the promises and perils of privatization in developing economies (Estrin and Pelletier, 2015). As the reader will doubtless note, this article is plenty long even without integrating already-surveyed articles into this summary paper.

Anyone attempting to write a survey article on a theme as broad as privatization and state ownership of business, even one concentrating on research generated over the past dozen years, must confront the challenge of organizing and presenting the mass of published research and working papers, and also put this research into the context of real economic developments. I will adopt a policy of categorizing the post-2004 research into three principal areas: (1) empirical privatization studies; (2) theoretical and empirical studies examining the level, type, and valuation impact of state ownership of business enterprises; and (3) empirical research examining the impact of state ownership on financial markets and institutions, plus the private and public social welfare implications of political connections between politicians and business executives. As an organizing principle, I will summarize the objectives, sample/methodologies, and results of key empirical and theoretical studies in each section of this paper in the form of eleven tables spread throughout the three topical sections. Over 100 articles are summarized in these tables, and presenting this information in tabular form allows me to economize on textual discussions of each paper's objectives and findings and concentrate instead on synthesizing the research in text discussions. The perceptive reader will soon note that many of these articles are presented in two different tables, since any particular article may analyze, say, both the determinants of why companies are selected

for privatization and the effectiveness of privatization in improving company performance, or both the determinants of the level of state ownership in a particular country or industry and the valuation effect of that state ownership.

In order to place this research into real economic context, I will begin each section with a statistical overview. This will involve showing, as examples, how much privatization has actually occurred over the past dozen years and predicting where the policy is headed worldwide, as well as examining the current level of state ownership in various regions and industries and assessing how state-owned enterprises are valued relative to privatized and always-private companies.

### **1.1 Megatrends in Privatization and State Ownership Examined in This Survey**

Viewed from a high level of abstraction, seven major themes can be observed by anyone studying the evolution of privatization and state ownership of business in the early years of the 21<sup>st</sup> century. These themes will be addressed, directly or indirectly, in various sections of this survey, and are presented in bullet form below. Given these conflicting influences, it is difficult to compute whether the net level of state ownership and influence has truly increased or decreased during this millennium.

- **The rise of China as a global economic power and as a competing model of business ownership and organization.** In 2000, China's GDP at market prices was \$1.21 trillion, and represented only about 3.6% of world GDP; by 2015 these values had reached \$11.06 *trillion* and 17.52%, respectively. Over this period, China became the world's leading manufacturer, leading exporter, and by some measures (such as GDP measured at purchasing power parity), the world's largest economy. Besides the sheer growth in economic weight, China's reliance on and support for state-owned and/or state-influenced "national champions" in key industrial sectors has prompted many observers to conclude that the country is explicitly adopting the same model of "state

capitalism” that earlier Asian pioneers used successfully in their take-off phases. Other nations, such as Brazil, India, Russia, and Singapore have also risen to global prominence with business sectors dominated or heavily influenced by government-controlled companies.

- **Outside of China—and Russia—state ownership of business assets has increasingly taken the form of portfolio equity investment by governments and state-owned investment funds, rather than direct ownership/operation of state-owned enterprises.** The historic use of state-owned enterprises as tools of government industrial policy has been well documented. What is far less appreciated is the high frequency with which governments have been buying equity in listed and unlisted private firms. Contrary to public perceptions and despite the worldwide success of state privatizations, over the 2001-2012 period governments actually *acquired* more assets through stock purchases (\$1.52 trillion) than they sold through share issue privatizations and direct sales (\$1.48 trillion).<sup>1</sup> Much of this state investment was channeled through sovereign wealth funds—which grew from less than \$1 trillion in assets under management in 2000 to over \$6 trillion AUM in early 2016—and the vast bulk of these stock purchases have been cross-border transactions. At the same time, another set of governments has continued actively privatizing SOEs and other state assets through public share offerings and direct asset sales. Figure 1.1 shows the annual value of state purchases of equity (nationalizations) and sales of assets and equity (privatizations) between 1988 and 2013. The world has thus been witnessing two powerful, simultaneous, and apparently contradictory economic phenomena over recent years: continuing sales of state-owned assets and enterprises to private investors by

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<sup>1</sup>Reported in Megginson (2013, Figure 3.2), based on data from the Thomson Reuters SDC Platinum M&A database and Privatization Barometer (<http://www.privatizationbarometer.net>). During 2013, state asset sales (privatizations) reverted to the pre-2001 historical pattern, exceeding state purchases by more than \$50 billion, and the relative dominance of privatization over state purchases of corporate equity has increased since then.



**Figure 1.1:** Worldwide Sales of State-owned Enterprises and Assets (Privatizations and Sales) and Purchases of Privately-owned Stock by Governments (Nationalizations and Investments), 1988-2011.

Source: *The Economist*, Setting out the Store (January 11, 2014). <http://www.economist.com/news/briefing/21593458-advanced-countries-have-been-slow-sell-or-make-better-use-their-assets-they-are-missing>

some governments, coupled with increasingly large purchases of private, often listed, corporate equity by other governments.

- **The “middle innings” (2005-2014) of the early 21<sup>st</sup> century were transformed, financially and economically, by a massive rise in global oil prices that shifted power and wealth to (mostly) non-democratic petroleum exporting nations and their wholly state-owned national oil companies.** The rise in oil prices from below \$25 per barrel in 2004 to a high of \$147/barrel in 2008 and an average of over \$100/barrel for 2010-14, when multiplied by period-average global production of about 90 million barrels per day, enriched a set of countries with rentier economies dominated by state-owned enterprises, and gave these societies unprecedented sway over the world’s most important

commodity. On the other hand, the collapse in oil prices that began in 3Q2014 and continues to the present day presages an even more dramatic likely shift in global economic power, and probably a surge in privatization of the formerly sacrosanct NOCs, beginning with Saudi Aramco in 2018.

- **The Global Financial Crisis of 2008-10, and governments' subsequent policy responses, reversed—at least temporarily—the long term trend towards lower state intervention in and ownership of business.** The sudden collapse of Lehman Brothers in September 2008, following a slower but almost equally corrosive meltdown of the US subprime mortgage lending market, triggered a global financial and economic crisis unmatched since the Great Depression of the 1930s. In response, many governments took emergency action to rescue banks and other financial institutions, often partially nationalizing these in the process. Outside the United States, governments have been slow to unwind these ownership stakes, which has halted the long-term trend towards lower state ownership of business in many countries, particularly Europe. Rescues of American banks through capital infusions by the federal government put the United States in the odd position of being the world's largest government buyer of corporate equity during 2008 and 2009, and subsequently the world's largest privatizer during 2009, 2010, and 2012. In immediate response to the crisis, the world's major central banks flooded markets with liquidity and sharply lowered interest rates, and later embarked on a series of increasingly unorthodox actions—particularly quantitative easing—designed to rekindle economic growth and avoid deflation. The financial distortions and record low interest rates engendered by these policies endure to the present day, though most of the world's key central banks began modest tightening in 2017.
- **The economic and political unity of Europe increased significantly after the introduction of the euro in 1999 and the expansion of the European Union by ten member**



**states in 2004, but Europe entered an extended period of instability and crisis after 2011.** The introduction of the euro as the currency of most continental European countries went far more smoothly than predicted, and seemed to function synergistically for Eurozone member state for over a decade. Then financial crises in Spain, Portugal, Ireland and, especially Greece ushered in a seemingly endless round of “rescues” by the European Central Bank, the IMF, and member states—particularly Germany. The austerity measures imposed as a condition for these rescues, though perhaps necessary, have yielded low or negative economic growth and rising political tensions throughout much of Europe. The “Brexit” vote in June 2016 appeared to symbolize Europe’s disarray and increasing disunity, though continental European elections in France and elsewhere in 2017 suggested the enduring relevance of the European Union as a political force and the euro as a global currency.

- **Privatizations continued after 2000, and in some years even accelerated, but the pattern of global privatizations shifted from secondary-share public offerings in western Europe to a wide variety of divestment methods in emerging markets, especially China.** European privatizations represented roughly half of the world’s total value of all divestments during the years 1988-2000, the “Golden Age of Privatization,” but the total value of European privatizations dropped sharply during 2001-03, and Europe’s share of global privatization proceeds has averaged less than 25% since 2009. Instead, emerging market countries such as Turkey, Brazil, Russia, India and especially China took over as leading privatizers most years—with the United States leading the world in 2009, 2010, and 2012. Furthermore, China almost uniquely privatizes companies by allowing SOEs to raise capital by selling newly-issued primary shares to investors, thus diluting state ownership only indirectly by increasing total shares outstanding, rather than having the state sell its existing shareholdings directly to investors. This policy hugely increased the size and liquidity of China’s stock market, but also

forced the government to shut down China's IPO market during 2005-07 as it implemented a major split-share structure reform that allowed state-controlled investors to exchange their heretofore non-tradable shareholdings for tradable shares. As a core global economic policy, privatization remains in robust health, with a record \$320 billion being raised through privatization sales in 2015, and over \$1.189 *trillion* being raised between January 2012 and December 2016 (Megginson, 2017).

- **The types of assets privatized since 2004 has broadened to include far more infrastructure assets and smaller state-owned enterprises.** While governments have long included certain infrastructure assets in their divestment programs, the scale of infrastructure divestment has increased massively since 2004, particularly in the Middle East and Asia. Governments have taken to selling airports, telecom networks, seaports, and even entire electricity grids either to specialist operating companies or globally active institutional investors seeking long-lived investments with stable cash flows. Unsurprisingly, such assets are much more likely to be divested via an asset sale—often involving an auction—than via a share issue privatization.

Unsurprisingly, the academic research examining privatization and state ownership has also evolved rapidly over the past dozen years, mirroring the momentous political, financial, and economic events described above. The number and quality of empirical studies examining Chinese state-owned enterprises and investment funds have increased dramatically; the perceptive reader will note that over a third of the studies cited in this survey employ Chinese data exclusively. New empirical methodologies have been adopted, allowing much better identification of economic, financial and policy event-dates and impacts. Two examples of this empirical innovativeness are the implementation of difference-in-difference estimation techniques and the search for quasi-natural experiments such as major policy changes or unexpected market valuation shocks. Nonetheless, the difficulty of sorting out causality continues to bedevil privatization research, and it often remains unclear whether

and how macroeconomic and political innovations lead to changes in the level of privatization or whether privatization itself is one of the core elements of political and economic change. Many more researchers have examined how state ownership impacts corporate financial policies—such as capital investments, cash holdings, and the cost of capital—than in previous years, thus allowing for better estimation of the overall impact of government ownership of or influence on the financial management of target companies.

Entirely new avenues of research have also emerged since 2000. Soon after sovereign wealth funds rose to prominence as global investors in 2007-08, the first of a series of empirical studies appeared examining both the announcement-period stock market returns of target companies and the long-run impact of SWF investment on operating performance. Several empirical studies examining the impact of state ownership and privatization in that most important of global industries—petroleum exploration, production, and refining—were produced and published after oil prices began rising sharply in 2005. Perhaps most intriguingly, the new millennium has seen growing research interest in the importance of political connections between politicians and business executives in both state and privately-owned businesses. While it has long been known that political connections were valuable for the companies and politicians involved, recent research has also documented the social welfare costs such connections might impose on the overall economy.

## **1.2 Organization of the Survey**

This paper is organized as follows. First, I will survey the recent empirical privatization research in section 2, beginning with a summary of studies examining whether divestment improves the performance of newly privatized companies, but also encompassing related research assessing which companies will be privatized, as well as when, how, to whom, and at what price the state enterprises will be divested. Second, I will summarize the empirical and theoretical research examining the level, type, and valuation impact of state ownership in the world's major economic regions in section 3. This summary will also assess research examining the relative efficiency of state versus private ownership, and

the effect of state ownership on observed corporate financial policies, such as capital investment and cash holdings. This will be the longest and most amorphous body of literature surveyed. Third, I will summarize the empirical research examining the intersection of state ownership and finance in section 4. This will begin with the literature assessing the rise of sovereign wealth funds, then will survey research examining the efficiency of state owned banks—as well as the related issues of the effectiveness and welfare implications of state bailouts of failing banks and government loan and deposit guarantees—and will conclude by summarizing research questioning the private and public social welfare implications of political connections between politicians and business executives. Section 5 concludes.

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