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Reluctant regulation ☆

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We study the effect of state ownership on the market-to-book ratios of publicly traded European utilities from 1994 to 2005. We find that when the company is subject to independent regulation, state ownership seems positively associated with firm value. This relation tends to appear in countries where weak checks and balances and political fragmentation do not constrain the power of the executive. Our results suggest that, where political institutions are weak, politicians may influence regulatory agencies in order to benefit state-owned firms. *Journal of Comparative Economics* **41** (3) (2013) 804–828. Universita' di Torino, Dipartimento di scienze economico-sociali e matematico-statistiche, C.so Unione Sovietica 218/bis, 10134 Torino, Italy; Universita' Bocconi, Paolo Baffi Centre, Via G. Roentgen 1, 20136 Milano, Italy; Politecnico di Torino, DIGEP, Corso Duca degli Abruzzi 24, 10129 Torino, Italy.
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"How can the state regulate the firms it also runs?"
The Economist (22-01-2012, p. 17)

1. Introduction

Three decades after the start of the largest transfer of ownership in the history of the corporation, privatization is fading away. Since the turn of the century, the divestiture of state assets has slowed down in most developed economies and somehow progressed in emerging countries due to the floating of large State-owned Enterprises (SOEs). However, the most common outcome of this worldwide process is the persisting government control of (partly) privatized firms, a qualifying feature of the so-called "rise of state capitalism".[1] Interestingly, and contrary to conventional wisdom, residual control rights by the government do not affect negatively the value of the firm. Recent evidence has shown that partial, not full, privatization

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[1] According to a recent report on state capitalism, the combined market value of global SOEs is more than $2 trillion and total employment around 6 million (*The Economist*, January 21st, 2012).

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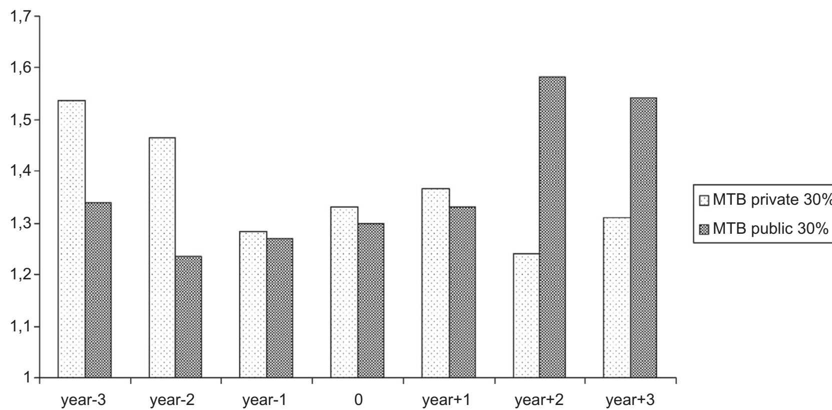

Fig. 1. Market-to-book ratios at the IRA inception, before and after the event. (Sample: firms undergoing the change in regulatory regime; ownership threshold at 30%.)

improves financial and operating performance (Gupta, 2005) and that firms under government control tend to be more valuable than fully privatized firms (Beltratti et al., 2007; Bortolotti and Faccio, 2009).

Public utilities, i.e. firms operating in network industries, such as energy, telecommunication, transportation, and water, had a great bearing in past privatizations. In most developed countries, sales advanced in parallel with deep structural reforms promoting liberalization and regulation of former state monopolies to boost efficiency and private investment.[2] In the European Union, for example, the Commission urged the member states to establish Independent Regulatory Authorities (IRAs), i.e. autonomous public agencies to which governments were to delegate regulatory policy. Yet, government control of privatized/regulated firms is commonly observed also in public utilities.[3]

We observe that residual ownership by the government does not affect negatively the market value of regulated utilities: higher state ownership is associated to higher firm value, but this happens only when the firm becomes subject to an IRA. Fig. 1 illustrates the evolution of market-to-book ratios of European telecoms and energy utilities before and after the official establishment of respective IRAs. We notice that, on average, in the 3-year period after the event, state-controlled firms outperform privately controlled firms by 15 percent.

The aim of this paper is twofold: first, we investigate the effect of government ownership on the market value of public utilities, controlling for other possible determinants. Second, should this relation exist, we try to establish the channel linking government ownership to the value of firms regulated by IRAs. To this purpose, we use an original panel of 88 European publicly traded network utilities from 1994 to 2005, which includes 10 of the top 30 companies in terms of market capitalization within the European Industrial Sector (Mediobanca Investment Bank, 2009). Our estimates rely on cross- and intra-country variation in the data around regulatory reforms and political institutions.

Why should governments own firms? Conventional wisdom and a bulk of theoretical literature suggest that politicians are ‘‘bad owners'' of corporations as they typically impose objectives that destroy shareholders' value (Shapiro and Willig, 1990; Shleifer and Vishny, 1994; Bennedsen, 2000).[4] At the same time, politicians are also viewed as ‘‘bad regulators'', since their interference may lead to time-inconsistent regulatory decisions and to the expropriation of utilities' sunk investments (Stigler, 1971). These arguments typically provide the rationale for the privatization of SOEs, insofar as the transfer of ownership rights to the private sector improves incentives and boosts operating performance (Megginson and Netter, 2001), and for the setting up of IRAs, in order to foster the credibility of regulatory commitments (Levy and Spiller, 1994; Baldwin and Cave, 1999).

However, the existence of a legally (*de jure*) independent regulator is not sufficient to ensure real (*de facto*) independent decisions, because genuine independence hinges, among other things, upon the actual powers that the political system delegates to the agency, in other words upon the residual rights to intervene in regulatory decisions retained by incumbent politicians.[5] We label *reluctant regulation* the institutional setting whereby regulatory powers are delegated to a formally independent regulator, but *de facto* subject to political interference by the government.

Reluctant regulation matters when the government retains significant ownership rights in regulated firms. In this case, politicians may wield their powers to obtain favorable regulatory decisions that boost utilities' profitability, and this in turn allows the government, for example, to raise additional fiscal revenues via extra-dividends and to avoid tax increases,

[2] Utilities accounted for two thirds of the privatization revenues raised in European countries from 1977 to date (Privatization Barometer, 2010).

[3] In the European Union, 85% of privatized utilities are under government control (Roland, 2008).

[4] In this perspective, privatization can be seen as a safeguard against the opportunistic behavior of politicians (Sappington and Stiglitz, 1987). See also the recent survey by Martimort (2006).

[5] Alesina and Tabellini (2008), studying the normative criteria that allocate tasks between politicians and bureaucrats, point out that regulation of public utilities is an example of ‘‘policies that lend themselves to bureaucratic delegation, since they pit special interests against those of consumers as a whole''. However, such a delegation comes to a cost in terms of the loss of political control over the industry leading to *imperfect* delegation of power. In fact, ‘‘institutions are more likely to be designed so as to deliver maximal rents at the lowest risk for the incumbent politician'' (page 444 and 445).

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