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# The political economy of share issue privatization: International evidence☆

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ABSTRACT

Using a large sample of 3266 privatization transactions from 100 countries over the period 1977–2006, I test hypotheses on the political underpinnings of the choice of privatization method. After controlling for firm-level characteristics and cross-country legal institutions, I find that the political system's type, tenure, and cohesion explain the choice between privatizing with a share issue or an asset sale. My results are robust to a series of sensitivity tests and suggest that the government's choice of privatization method is politically constrained at different levels.



## 1. Introduction

Privatization activity has grown markedly over the past three decades, reaching almost every country in the world and bringing with it major changes in capital markets, corporate governance, economic activity, and performance. Despite being widespread, however, privatization is not effected uniformly across countries. Governments typically prefer share-issue privatizations (SIPs) because they involve a large number of domestic investors, promote popular capitalism, and help create an equity culture that contributes to capital market development (Boutchkova and Megginson, 2000). McLindon (1996) and Subrahmanyam and Titman (1999) further argue that SIPs enhance stock market liquidity and

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efficiency by leading domestic firms to go public. Yet, despite these benefits of privatizing through share issues on the stock market, some countries employ assets sales characterized as "the sale of a majority stake to a single investor or to a consortium of investors that have been approved under some pre-qualification screening process" (Dyck, 2001, p. 77).

In an effort to explain the use of asset sales, Dyck (2001) and Megginson et al. (2004) argue that countries may resort to this mechanism whenever formal governance chains are relatively weak. Extant literature provides little empirical insight, however, into the impulse behind this particular choice of policy.[1] Indeed, as Megginson and Netter (2001) note, although academic research has allowed us to learn much about the sale of assets in well-developed capital markets, we still lack a good understanding of the determinants and implications of the choice of privatization method for state-owned assets. The purpose of this paper is then to answer this call by examining the political factors, shown recently to impact the privatization reform, that affect the choice of privatization method. In doing so, we contribute to the extant literature that only focused on government ideology and commitment to policy (e.g., Megginson et al., 2004). Indeed, the literature on the choice of privatization method seldom examines other relevant political dimensions that appear in recent studies on privatization (Boubakri et al., 2008, 2011; Bortolotti and Faccio, 2009; Dinc and Gupta, 2011; Ben-Nasr et al., 2012). More specifically, in this study I focus on the political system's type, tenure, and cohesion as determinants of the choice of privatization method.

My study is motivated by the importance for a government to choose between public and private markets, especially in countries in which capital markets are underdeveloped. SIPs can act as a tool to boost local stock markets' liquidity, and thus shedding light on the determinants of such a decision is likely to lead to important policy implications. In addition, from the corporate point of view, financing decisions of newly privatized firms (NPFs) are likely to impact future investment, growth, and performance: Relying on private versus public markets affects the way control is subsequently allocated among owners and hence will affect the post-privatization corporate governance of the firm,[2] which in turn will determine performance. All these observations motivate my examination of the determinants of the choice of privatization method, focusing on the political factors while controlling for firm- and country-level variables.

In many ways, a government's decision with respect to the privatization method is similar to a firm's choice regarding whether to rely on private or public capital markets for financing (Megginson et al., 2004).[3] The observed choice of divestiture method can thus be viewed as a choice with respect to corporate governance structure. The "legal origin view" of finance stipulates that corporate governance and financial and economic development are shaped by a country's legal origins and the legal institutions in place. This view has largely dominated the literature since the seminal work of La Porta et al. (1997) but has been recently challenged by scholars who instead advocate a "political institutions view" of finance and corporate governance (e.g., Roe, 2006; Roe and Siegel, 2011). For instance, a number of theoretical papers emphasize that a country's legal institutions are an adaptive product of the historical and political environment (Glaeser and Shleifer, 2002). In the same vein, Milhaupt and Pistor (2007) emphasize that it is the political economy of a country that determines whether the country's legal system is stable and secure. In this paper, I extend the existing literature on the determinants of the method of divestiture (Megginson et al., 2004; Guedhami and Pittman, 2011) by considering the joint impact of country-level legal and political institutions on the choice of corporate governance structure (i.e., privatization method).

To examine whether a political system's tenure, type, and cohesion influence a country's privatization policy, I rely on the Database on Political Institutions compiled by the Development Research

[1] A substantial body of literature examines the financial and operating performance implications of privatization (Megginson et al., 1994; Boubakri and Cosset, 1998; Frydman et al., 1999; Boubakri et al., 2005). Other studies focus on the initial and long-term returns to investors in share issue privatizations (Jones et al., 1999; Megginson et al., 2000; Choi et al., 2010). A third strand of literature examines post-privatization ownership patterns (Boutchkova and Megginson, 2000; Boubakri et al., 2005; Bortolotti and Faccio, 2009).

[2] Private sales to private investors, mostly foreigners, often lead to more concentrated ownership after privatization. In contrast, SIPs are characterized by a more dispersed ownership structure.

[3] A notable difference, however, is that issuers of privatization IPOs (i.e., governments) are constrained by a set of political factors and are characterized by political dimensions that no typical firm exhibits.