



**The Decision to Privatize:
Finance, Politics and Patronage**

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Why privatize?

- Increase efficiency of state-owned firms
 - Performance improves after privatization (La Porta & Lopez-de-Silanes, 1999; Megginson & Netter, 2001; Gupta, 2005)
- Raise revenues from privatization proceeds
 - > \$1 trillion raised from privatization sales (Megginson & Netter, 2001)
- Develop stock markets
 - Market value of privatized SOEs increased from <\$50B in 1983 to \$2.4T in 1999 (10% of world stock market capitalization) (Megginson et al., 2004)

Yet... governments can't seem to let go

- Governments retain majority ownership in SOEs in many countries (La Porta et. al, 2002, Bortolotti et al., 2004)
- In India only 50 of 280 federal government owned firms have sold equity
- Do politicians' career concerns and private benefits affect the decision to privatize?

The Political Economy of Privatization

- Benefits from privatization are *dispersed*
 - Revenues go to the state
 - Efficiency improvements are captured by consumers and tax payers
- Costs of privatization are *concentrated*
 - Layoffs of surplus workers
 - Loss of private benefits for politicians
 - Costs may be *geographically concentrated*
- Special interests may capture the policy process

Political Factors

“The Indian voters were rejecting the National Democratic Alliance (NDA) government, which, as one poll slogan had it, stood for the “National Disinvestment Agency” (The Hindu, May 14, 2004)

- Costs likely to be geographically concentrated → reduce support for governing party in that region
- **Political Competition**
 - Effect of voter backlash may be greater if governing and opposition parties in a close race
 - *Delay privatization in states where governing party faces a close race with opposition parties*

Political Factors

- Political Strength
 - If governing party has weak support where firm is located then it may lose votes by privatizing in that region
 - Or, it may reward supporters by not privatizing in regions where it is strong
- Political Patronage
 - Politicians get rents from SOEs such as jobs for political supporters; corruption (Shleifer and Vishny, 1994; Boycko, et al. 1996; Dinç, 2005)
 - Loss of rents may matter more if firm is located in the home state of the politician

Results preview

- A firm is *less* likely to be privatized if its main operations are located in a state
 - where the party in power is in a close race with opposition parties.
 - where the party in power did not win a large share of the seats
- No firm located in the home state of the Cabinet minister in charge of that firm is privatized

Literature

- Perotti (1995), Biais and Perotti (2002)
 - Governments partially privatize firms to signal credibility.
 - Conservative governments more likely to privatize.
- Jones, et al. (1999); Megginson, et al. (2004)
 - Privatization method consistent with political objectives.
 - Share issue privatization more common in less developed markets.
- Clarke and Cull (2002)
 - In Argentina unprofitable banks with surplus employment more likely to be privatized.

State-owned Firms in India

- Federal government-owned firms account for 25% of GDP and 43% of capital stock in 2000
- Half of the firms are chronically loss making
- Subsidies to 300 firms > 5% of GDP
- Overstaffed with overpaid workers – average ratio of wages to sales twice that of private firms
- *Disinvestment* launched with 1991 economic reforms

Elections & Disinvestment

1991 - 1995

- Congress Party and allies in power in *Lok Sabha*; BJP main opposition.
- 39 (out of 280) firms partially privatized. No majority stakes sold.

1996 - 1999

- Multiple elections, coalition governments include JD and BJP.
- No new firms privatized.

1999 - 2004

- BJP and allies in government; Cong and allies opposition.
- 10 new firms privatized. Majority stakes sold.

2004 - present

- Cong in government, BJP in opposition.
- 1 new firm privatized.

Data

- Firm level balance sheet data on federal government owned firms, fiscal 1990-2004 (CMIE)
- Location of main operations of firm (CMIE and hand collected)
- Privatization data (hand collected from government sources, news reports)
- State-level election data (Election Commission of India)
 - All federal (5) and state assembly elections (107) held since 1991
- Data on Cabinet ministers and their jurisdiction (hand collected)

Comparing Privatized to Not-Privatized Firms

(Table 3)

<i>Variables</i>	<i>Privatized</i>	<i>Not Privatized</i>	<i>All</i>
<i>Govt Seat Share (%)</i>	50.8* (33.0)	46.0 (34.1)	46.4 (34.0)
<i>Opposition Seat Share (%)</i>	26.8 (29.8)	23.8 (26.6)	24.0 (26.9)
<i>Abs Seat Share Difference (%)</i>	55.2*** (25.2)	47.4 (29.5)	48.0 (29.3)
<i>Number of Firm-years</i>	184	2121	2305

Regression Specification

$$h_i(t) = h_0(t) \exp(\beta'x_i(t) + \gamma * \textit{Political Factors}_i(t))$$

- Cox proportional hazard analysis for the time until privatization
- Privatization defined as first sale of equity
- Errors are clustered at the state level
- Industry dummies are included
- *Null Hypothesis*: Privatization decision not related to the ruling party's political strength or the political competition it faces in the state where a firm's main operations are located.

Political Strength and Competition (Table 5)

	(1)	(2)	(3)	(4)	(5)
<i>Ln(Sales)</i>	0.798*** (0.162)	0.805*** (0.176)	0.774*** (0.169)	0.807*** (0.177)	0.775*** (0.169)
<i>Profit/Sales</i>	1.997** (0.898)	1.912** (0.950)	1.854** (0.898)	1.912** (0.949)	1.854** (0.894)
<i>Wages/Sales</i>	-3.463** (1.480)	-3.181** (1.446)	-3.273** (1.451)	-3.171** (1.456)	-3.267** (1.458)
<i>Govt Seat Share</i>		0.723** (0.347)		0.742** (0.351)	
<i>Abs Seat Share Difference</i>			0.793* (0.425)		0.809* (0.438)
<i>State Govt Majority</i>				-0.111 (0.332)	-0.082 (0.329)
<i>Industry FE</i>	Yes	Yes	Yes	Yes	Yes
<i>Observations</i>	2365	2365	2365	2365	2365

Politics & Privatization

- The party in power is more likely to privatize a firm located where it is strong
 - From 25th to 75th percentile in *Govt Seat Share* → 70% faster rate of privatization
- Less likely to privatize a firm where it faces a close race
 - From 25th to 75th percentile in *Absolute Seat Share Difference* → 63.5% faster rate of privatization

Robustness of Political Results

- Results are robust to
 - Alternative political measures
 - State legislature elections
 - Political ideology
 - State-level characteristics
 - Alternative samples and specifications

Ideology and state-level factors (Table 7)

	(1)	(2)	(3)	(4)	(5)	(6)
					<i>Largest States</i>	
<i>Ln(Sales)</i>	0.821*** (0.193)	0.788*** (0.181)	0.818*** (0.172)	0.782*** (0.164)	0.842*** (0.243)	0.787*** (0.235)
<i>Profit/Sales</i>	1.945** (0.986)	1.889** (0.933)	1.962** (0.943)	1.895** (0.895)	3.068*** (0.823)	2.933*** (0.871)
<i>Wages/Sales</i>	-3.117** (1.507)	-3.205** (1.521)	-3.200** (1.438)	-3.295** (1.425)	-2.006 (1.822)	-2.282 (1.857)
<i>Govt Seat Share</i>	0.694* (0.368)		0.821** (0.338)		0.985*** (0.369)	
<i>Abs Seat Share Difference</i>		0.727* (0.408)		0.965* (0.522)		1.437*** (0.350)
<i>Ln (Per Capita Income)</i>	-0.402 (0.458)	-0.357 (0.440)				
<i>Per Capita Income Growth</i>	-0.697 (1.990)	-0.709 (1.956)				
<i>Literacy rate</i>	0.020** (0.008)	0.019** (0.008)				
<i>Leftist Seat Share</i>			0.511 (0.748)	0.596 (0.763)		
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2363	2363	2365	2365	1875	1875

The Role of Political Patronage

	<i>Privatized</i>		
<i>Plant in Home State</i>	No	Yes	Total
No	188	38	226
Yes	17	0	17
Total	205	38	243
Correlation	-0.118*		

- *No firm located in the home state of the Cabinet Minister in charge of that firm is privatized*

Effect of Privatization on Firm Performance

Panel A: Second Stage Regressions with Firm Performance			
	(1)	(2)	(3)
	<i>Sales Growth</i>	<i>Profit Growth</i>	<i>Growth in Wages/Sales</i>
<i>Privatized</i>	0.502*** (0.192)	0.541*** (0.165)	-0.132* (0.070)
<i>Ln(Sales)</i>	-0.048 (0.033)	-0.120*** (0.029)	-0.003 (0.012)
<i>Profit/Sales</i>	0.483** (0.238)	0.658*** (0.204)	-0.301*** (0.089)
<i>Wages/Sales</i>	0.259 (0.179)	0.175 (0.150)	-0.022 (0.067)
Industry FE	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes
Observations	289	291	289

Panel B: First Stage Probit

<i>Govt Seat Share</i>	
<i>Ln(Sales)</i>	1.432* (0.877)
<i>Wages/Sales</i>	2.313*** (0.536)
<i>Profit/Sales</i>	-5.689* (3.009)
Industry FE	9.740*** (2.689)
Year Dummies	Yes
	Yes

Summary of Results

- A firm is *less* likely to be privatized if its main operations are located in a state where
 - **The governing party faces a close race with opposition parties**
 - **The governing party did not win a large share of the seats**
- No firms located in the home state of the Cabinet Minister in charge of the firm are privatized.
- Privatization has a positive effect on firm performance when treated as endogenous using political variables as IV