

2. LITERATURE REVIEW

This literature review is divided into two sections, Privatisation Perspectives and Corporate Governance Perspectives. The former section describes theories that support privatisation while the latter describes the corporate governance theories.

2.1 Privatisation Perspectives

Privatisation - the transfer ownership of assets or service delivery from public to private hands - has been extensively carried out in the developed as well as developing economies in the past two decades. At the beginning of the 1980s, neo-liberal arguments were dominant in many parts of the world. The neo-liberal understanding then was government involvement in the economy has been excessive and hence state intervention need to be reduced in favour of the market. The state's failure in allocating resources efficiently was attributed to the state becoming 'captive' to special interests of powerful organised groups, rich business people and trade unions (Friedman, 1969). Other arguments against the state include excessive and redundant administrative costs in the redistributive programmes by the state. At the end of the 1980s the demise of the centrally planned economies in Eastern Europe help support this contention.

Theories that support privatisation are very diverse but they also overlap each other. In general there are two basic theories that support private ownership. The property rights theory and the dispersed knowledge theory. Other neo-liberal theories are built

based on the classical theories. However some new theories suggested ownership does not matter but instead the focus should be on competition and regulation.

2.11 Neo-Classical Property Rights Theory

The neo-classical property rights school suggests that communal ownership will lead to dissipation (Clarke and Pitelis, 1993). The property rights school believes that efficiency incentives in communal ownership are distorted because of the lack of property rights by its members. A widely known variant of this theory is 'the residual claimant theory' by Alchian and Demsetz (1972). This theory suggest that members of a firm that is the management and other employees needs to be residual claimant of income generating assets in the absence of which they will tend to free ride, thus leading to inefficient utilization of resources.

Therefore private ownership gives its members as residual claimant to the profit of the firm an incentive and motivation to maximize profit by putting maximum effort to the production of the firm. On the other hand, bureaucrats managing state owned enterprises do not have such an incentive. There are other neo-liberal arguments on privatisation based on the property rights theory. They are the Public Choice Theory and the Theory of Government/Bureaucratic Behaviour.

(a) Public Choice Argument

Building on the property rights approach, public choice literature makes a similar argument but stresses the allocative inefficiency that is likely to arise as a result of

both interest group politics and a lack of competition faced by public producers (De Alessi, 1980). This situation also includes the regulated private firm. The regulation of privately owned firms by government implies an attenuation of owners' rights, and the management of firms by government employees implies a further attenuation.

(b) Theory of Government/Bureaucratic Behavior

Another argument that draws on both property rights and public choice theory is the theory of government/bureaucratic behaviour. This theory was developed by Niskanen (1975). The theory is a combination of the conventional theory of demand for government services in a representative government and the theory of bureaucratic supply. He called it the theory of bureaucracy and representative government. The emphasis of this theory is on bureaucratic incentives and norms that are unlikely to enhance efficiency in either production or regulation. In essence, the theory looks at the relationship between an elementary bureau which produces government services and the government review group or legislatures that monitors and buy the services produced by the bureau. The relationship is a bilateral monopoly with one buyer and one seller. In this bilateral relationship, the bureaucrats produce an output that maximizes their utility by maximizing their budget rather than profits. On the other hand, the legislature's preferred output is the output that will maximize their votes in the next election. Niskanen (1975) concluded that in general the bureau's budget is always too large and the output is also generally too large. Therefore there is a potential for 'public failure', and market failure may not be a sufficient argument for state intervention. Although motives such as nationalism and pride in serving the public can motivate public sector managers toward good performance, Niskanen's

arguments cannot be discounted because the dangers of bureaucratic self-seeking by the public sector managers exist.

2.12 Dispersed Knowledge Theory

According to the dispersed knowledge theory from the Austrian School, the nature of human knowledge, including economic knowledge is such that it is widely dispersed (Rowthorn & Chang, 1993). It can never be fully codified and transmitted to others (Hayek, 1949). Since knowledge cannot be fully transmitted to others, it is difficult for the state, as a hierarchical system to get all the information needed for decision making. Efficient acquisition and utilization of such knowledge can only be achieved through price signals provided by markets (Pitelis & Clarke, 1993). Therefore the reasoning is that the state is more ignorant than individual private owners. So it is better for the individual private owners with better knowledge to make the decisions than leaving it to the state.

2.13 New Theories

The previous theories suggest that deregulation will enhance efficiency by reducing inefficient operations that developed because of regulations and because firms were insulated from competition. It also suggests that rents accrued to well-organized groups benefiting from regulation would be dissipated by competition. But generally, these theories do not provide a case for private ownership. According to Yarrow (1986), competition and regulation are likely to be more important determinants of economic performance than ownership. This is because there is no clear empirical

evidence to prove that private production is preferred to public production. Thus in the event of an inefficient operation, the policy priority should be to increase competition and improve regulation.

(a) Contestable Markets Theory

The contestable markets theory (Baumol, 1982) support this argument. According to this theory, a monopoly or an oligopoly operating in a particular market does not in itself imply market power if there is no barriers to entry and exit. When entry and exit is completely free, the incumbent firm is forced by the potential entrant to produce efficiently in order to keep out the potential entrant. Therefore the conclusion from this theory is that government should seek policies that promote contests for markets. There is no need for privatisation or a change of ownership. The incumbent firm will have to produce efficiently whether or not it is publicly or privately owned. In order to promote contestable markets, Baumol (1982) suggested that governments should not resist the closing down of unprofitable activities.

(b) Soft Budget Constraint

Another common argument against public ownership but not necessarily in support of privatisation is based on the notion of 'soft budget constraint' as proposed by Kornai (1979). According to this argument, the public enterprises do not have the incentive to economize on resources because they can always claim more resources from the state budget. So the best solution is to establish a 'hard budget constraint'. However in certain conditions, the imposition of a hard budget constraint may not be possible

because of opposition from those who are affected negatively. In this case, privatisation is the second best option because with the enterprise in private hands, the political pressures will be weakened.

(c) Political Arguments

Drawing on these theories, Rowthorn and Chang (1993) argued that the performance of public enterprises lies in the realms of politics rather than pure economics. They argued that public enterprise efficiency depends on the attitude of the state towards competition and budgetary policy. On top of that it also depends on the state's ability to insulate itself against political pressures from inside and outside these enterprises. If the state can avoid the political pressures, the public enterprise may be able to perform just as well as a private enterprise. Rowthorn and Chang (1993) believe that if the political pressures cannot be avoided, then privatisation may be more efficient. However they cautioned that the political forces could still influence state policy after privatisation.

An important factor in political economy is income distribution. Since public enterprise performance is very much influenced by politics, its performance will tend to be very much affected by the income distribution consideration. Therefore an important aspect of privatisation is the effect of privatisation on income distribution. The transfer of ownership can create a shift in income distribution. Since state policies can be influenced by demands for income redistribution, privatisation can be used as a vehicle for this purpose. Politicians can use privatisation to transfer income and wealth to favoured interest groups.

According to Yarrow (1986), there are three factors that give rise to the redistributive effects. First, is the change in both the level and structure of output prices that may occur following privatisation. These changes will shift the distribution of income between producers and consumers. Second, is the price at which shares in an enterprise that is being sold are offered to the market. A discount on the market clearing price represents a transfer of wealth to the new owners at the expense of the tax payers. This is believed to be a reason why many privatised companies' shares open trading at a premium to its offer price. Third factor is the redistribution of income towards those associated with the provision of services that is used as inputs in the process of selling assets. In other words it is the transaction costs of privatisation. An obvious example is the underwriting fees and advertising fees paid to the respective parties for the privatisation exercise.

2.14 Empirical Evidence

Both the property rights theory and the dispersed knowledge theory suggest that private enterprises should perform better than public enterprises. However a review of the existing empirical evidence do not provide a strong support for this hypothesis. Comparative studies by Caves and Christensen (1980), and Atkinson and Halvorsen (1986) found no evidence of inferior performance by public enterprise or public enterprise is equally as efficient as the private enterprise. However, Boardman and Vining (1989) found that these studies are mostly based on North American firms that are not operating in a competitive environment. They revised the study by comparing

state owned enterprises (SOE), mixed enterprises (ME)¹ and private corporations (PC) in a competitive environment. In their 1989 survey, they reviewed 500 largest non-US industrial firms. The results show that large industrial mixed enterprises and state owned enterprises perform worse than similar private corporations. But the results are mixed between mixed enterprises and state owned enterprises. They concluded that partial privatisation where the government retains some percentage of equity may be worse especially in terms of profitability than complete privatisation or continued state ownership.

2.2 Corporate Governance Perspectives

Since the topic of corporate governance has been a rather important issue in the developed economies, a large literature has been written on the subject. The literature on corporate governance can be separated into two different perspectives, the economic perspective and the authority perspective. The term “corporate governance” may be relatively new in the English language but the issues relating to corporate governance can be traced back to the time of Adam Smith.

2.21 Economic Perspective

Economists try to understand corporate governance by looking at the link between “governance” and the theory of the firm. Corporate governance is essentially the governance of a corporation. Therefore an understanding of the theory of the firm is

¹ Mixed enterprises means that part of their stock is in private hands and part of it is in public hands.

needed. The word “governance” on the other hand is synonymous with the exercise of authority, direction and control (Zingales, 1997).

In a pure free market economy, there is no need for the notion of authority or control because Adam Smith’s invisible hand will ensure efficiency and every thing will be in equilibrium. However in the real world, there are externalities such as asymmetric or incomplete information (Ross, 1973, Simon, 1991) that will influence the function of the market. Furthermore in most cases production capital is highly specified and sunk. In a capital market transaction, investors who sink the capital need to be assured that they can get back the return on the capital. This is where corporate governance mechanisms come in. It provides this assurance. Although product market competition may reduce the returns on capital and hence cut the amount that managers can expropriate, it does not prevent expropriation after the capital is sunk.

(a) The Agency Problem

In a real world situation, a transaction will generate a quasi-rent outcome which needs to be divided ex-post (Zingales, 1997). This situation is also known as the agency problem. It came about because of the inherent structure of the firm, which separates ownership and control. In terms of ownership and control, the agency problem refers to the difficulties financiers have in assuring that their funds are not expropriated or wasted on unattractive projects (Shleifer & Vishny, 1997). Even though contracts between financiers and managers can specify the conditions of their relationship, contracts cannot fully specify exactly what the manager does in all situations and how the profits are allocated. This is because future contingencies cannot be predicted. To

resolve this problem residual control rights must be allocated (Grossman and Hart (1986), Hart and Moore (1990), Hart (1995)). Residual control right is the right to decide how the firm's nonhuman assets should be used given that a usage has not been specified in the initial contract (Hart, 1995).

(b) The Contractual View of the Firm

The agency problem is related to the contractual view of the firm developed by Coase (1937), Alchian and Demsetz (1972), Jensen and Meckling (1976), and Fama and Jensen (1983a,b). They view the organization as a nexus of contracts. These contracts, written or unwritten are the internal rules governing an organization. It specifies the rights of each agent in the organization, performance criteria on which agents are evaluated and the payoff functions they face. Since the firm is viewed as a nexus of contracts, therefore contracts have a major role in the allocation of quasi-rent. However it has a major drawback, when it is incomplete it will not fully specify the division of surplus in every possible contingency (Zingales, 1997, Simon, 1991). Managers holding significant control rights will have the freedom for self-interested behavior. This contract incompleteness creates room for bargaining.

(c) Corporate Governance Mechanism

Bargaining is influenced by the legal structure available. This is where corporate governance comes in. The corporate governance mechanisms will try to allocate this quasi-rent efficiently. Corporate governance mechanisms are economic and legal institutions that can be altered through the political process. Zingales (1997) defines it

as the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated in the course of a relationship. Examples of governance mechanisms include the market for corporate control, formal rules and regulations, and the board of directors.

Shleifer and Vishny (1997) take a pure agency view of corporate governance. The main focus of their research is on the investors and how investors persuade managers to give back their money with an added return. They defined corporate governance in the following way:

‘Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment’. (p.737)

Shleifer and Vishny’s ideal system of corporate governance combines both active large investors and the legal protection of large and small investor rights. They also noted that successful market economies such as US, Japan and Germany are governed through somewhat different combinations of legal protection and concentrated ownership. In contrast, most other countries lack mechanisms for legal protection of investors.

(d) Corporate Governance System

In Shleifer and Vishny’s (1997) narrow definition of corporate governance, there are two approaches for the corporate governance system. First approach is to give investors power through legal protection from expropriation by managers. This power

is given through the legal system. For shareholders, their legal right is the right to vote on important matters such as mergers and liquidations, and election of board of directors (Manne 1965, Easterbrook and Fischel 1983). They also have the right to appeal to the courts to enforce their rights. The managers on their part have a duty of loyalty to the shareholders or owners and this is enforced by the courts. For creditors, they have the right to the assets that serve as collateral, the right to liquidate the company, the right to vote in the decision to restructure the company and the right to remove managers in a restructuring. Grossman and Hart (1982) further argued that the threat of bankruptcy could induce management to perform better.

The second approach is to have large investors or concentration of ownership. This way will give the investors better control rights. Large investors can put pressure on management to perform. However there is a cost that comes with this approach. Large investors given greater control rights can expropriate minority investors because their objectives may not be similar. When this happens, efficiency of the firm could fall if the motivation and morale of the management and employees are affected. For the minority shareholders, the effects are a decline of external finance by them.

A way to overcome the agency problem is to have incentive contracts. Managers can be granted a long-term incentive contract ex ante to align his interests with those of investors. Incentive contracts can take the form of stock options, share ownership or a threat of dismissal if income is low (Jensen and Meckling, (1976), Fama (1980)). Incentive contracts are one of the ways that quasi rents can be distributed to the competing members of the firm.

There are three possibilities how a governance system can affect the division of quasi-rents and also the total surplus produced.

When faced with a particular situation, members of a firm will respond in the following manner:

1. They will not spend the optimal amount of resources in value enhancing activities that are not properly rewarded by the governance system (Zingales, 1997, Simon, 1991).
2. They will spend resources in inefficient activities, whose only purpose is to alter the outcome of the ex-post bargaining in their favour (Zingales, 1997)

Therefore, a governance system can promote or discourage these actions as it affects the incentive to invest or power-seek, as well as alter the marginal payoffs that these actions have in ex-post bargaining. (See, for example, Hill and Snell 1988, Baysinger et al. 1991, & Zahra 1996).

A second possibility is that a governance system can also affect the degree of information asymmetry between the members, the level of coordination costs or the extent to which a member is liquidity constrained (Zingales, 1997). All of which could change the ex-post bargaining efficiency. To support this contention, for example, if there is a large and dispersed group of shareholders, free-rider problems may prevent an efficient action from being undertaken – even if property rights are well defined and perfectly tradable (Grossman and Hart, 1980). The free-rider problem occurs when a shareholder cannot capture all the rents from getting involved, i.e. by exercising their vote, studying the enterprise, sitting on the board and taking

the risks of enhanced liability and additional costs. Since the gains will be split with other shareholders the gains from involvement will be reduced. In this situation a rational shareholder will consider foregoing involvement.

The third possibility is a governance system might affect the ex-ante value of the total surplus by determining the level and distribution of risk (Zingales, 1997). Members of the firm have different degrees of risk aversion. In this case, the governance system will allocate the risk to the most risk tolerant member (Fama and Jensen, 1983a and 1983b). The effectiveness of the governance system in allocating this risk might affect the total surplus. In addition to this, different governance systems can also generate a different amount of risk. An example of this is the life insurance contract quoted by Zingales (1997).

2.22 Authority Perspective

An important element of the governance system is authority. Authority is important to divide the quasi-rents generated. It is closely related to residual control rights. Arrow (1974) tackles the issue of corporate governance by looking at the balancing of authority and responsibility or the trade-off between accountability and enterprise. According to Arrow,

“Authority is viable to the extent that it is the focus of convergent expectations. An individual obeys authority because he expects others will obey it. ...the functional role of authority, its value in making the system work, plays a part, though only a part, in securing obedience. This functional

role will only be influential if in fact the authority is visible and is believed to be respected by others”. (p.72-73)

By raising the notion of respect, Arrow also give emphasis to the ‘social’ context of authority. Thus, from this perspective, corporate governance is embedded in the whole social make-up of the organization. It defines the behavior within and between organisations. Arrow recognized that what is important for corporate governance is how corporations can ensure that the potential gains from authority are achieved for the benefit of the company through the exercise of responsibility. He concluded that:

“There is much to be done in the design of institutions to reconcile the values of responsibility and authority... .To serve its functions, responsibility must be capable of correcting errors but should not be such as to destroy the genuine values of authority”. (p.77-78)

Simon (1991) linked the notion of authority with the employment contract. In an employment contract, workers maximize their utility by accepting the authority of the firm. The contract contains all sorts of implicit and explicit limitations and acceptable behavior. He also acknowledges that by nature the contracts are incomplete.

2.23 Political Economy of Corporate Governance

Corporate governance systems are primarily shaped by politics. Bennedsen (2000) studied the mechanics of this relationship by conducting a study on political involvement in resource allocation. Using this approach he explained that

privatisation does not remove politicians' interest in the enterprise, but will affect the organized interest groups action and thus affects the politicians preferred resource allocation. Therefore the interaction between the organized interest groups and the government could shape the structure of corporate governance.

For state ownership, the social welfare arguments such as monopoly power, externalities, distributional issues are used to justify its existence. Because of these issues, bureaucrats are thought to be able to improve efficiency by controlling the decision of firms and perform better than private firms. Although in theory these firms are controlled by the public, the de facto control rights belong to the bureaucrats. These bureaucrats have extremely concentrated control rights but no significant cash flow rights. Cash flow rights are effectively dispersed amongst the taxpayers of the country (Shleifer and Vishny, 1997).

Problems arise when the bureaucrats' objectives are not aligned with the social interests. In order to solve this problem, most countries responded by privatizing their state owned firms. Privatisation replaces political control with private control by outside investors. At the same time, it will create concentrated private cash flow ownership to go along with control.

Taking the definition of corporate governance by Shleifer and Vishny (1997) into consideration, privatisation increases the importance of corporate governance in these firms, as outside investors become its shareholders. Since corporate governance is shaped by politics, and in most cases, the political links of the privatised firm is not totally cut, it is interesting to note how a corporate governance system can remain

impartial and protect all the parties. The following sections discuss political influences on corporate governance for the United States and Malaysia.

(a) United States of America

Roe (1994) observed how the corporate governance structure developed in the United States. According to his findings, American politics played a major part in shaping the governance structure developed in the United States other than economic factors. Lobbying by interest groups also plays a part. He found that American politics deliberately weakened financial intermediaries, thereby making managers more powerful than they otherwise would be.

The American system favored smaller, local interests over concentrated private economic power. The interaction between firms and financiers are mediated partly by politicians. This makes politics as one of the determinants of corporate governance. The United States is one country where the banks do not hold major stakes in corporations. If the financial intermediaries were not suppressed, they could have taken big block of stocks and the development of the corporate governance system may be more similar with the systems in Japan or Germany. However, United States law fragmented intermediaries, and their ability to coordinate among themselves. Being big they would have influenced the managers but this is not the case.

(b) Malaysia

In Malaysia, there may be a link between privatisation, political ownership and corporate governance. Gomez and Jomo (1999) have indicated that in Malaysia, privatisation has led to concentrated ownership and political patronage. Privatisation is seen as an instrument to distribute rents. To accommodate the political objectives some of the governance mechanism has been ignored. An obvious case is the way the privatisation process was carried out. Competitive bidding or auction did not feature in most privatisation projects.

Even after privatisation, government ownership is still very high. This concentrated ownership may be costly. Shleifer and Vishny (1997) suggested that a large investor could redistribute wealth in both efficient and inefficient ways from others. When the state is a large investor it could easily use its position to redistribute wealth. Whether the redistribution is efficient or not depends on the policy makers/politicians who makes the decisions. Even though in theory concentrated ownership is suppose to solve the agency problem by giving control rights to the investor, if the investor is the state itself then the implications would be different.

There is no incentive for the politicians controlling the firm to maximize profit unless it is part of their political objective. The objectives of the state as an investor may differ from the objectives of the politicians. For example the objective of the state is to enhance welfare while the objective of the politicians is to enhance self-interests. When this happen the state institution itself could suffer from potential governance problems of a principal agent nature. There could even be a moral hazard problem.

With the state as shareholder, it is unlikely that the firm will fail because if the firm is in trouble it can always rely on the state for a bail out. The evidence is clear in the case of the renationalisation of the Malaysian Airline System Berhad.