Are public enterprises necessarily inefficient?

Privatization the problem, rarely the solution

by Jomo Kwame Sundaram

***Third World Network*, November & December 2016**

In the next two articles, takes issue with unqualified advocacy of privatization of public enterprises. The first article points to adverse effects of privatization, while the article which follows contends that state-owned enterprises can be run efficiently.

Are public enterprises necessarily inefficient?

***Third World Network*, November 2016**

From the 1980s, various studies purported to portray the public sector as a cesspool of abuse, inefficiency, incompetence and corruption. Books and articles with pejorative titles such as “vampire state”, “bureaucrats in business” and so on thus provided the justification for privatization policies.

Despite the caricature and exaggeration, there were always undoubted horror stories which could be cited as supposedly representative examples. But similarly, by way of contrast, other experiences show that state-owned enterprises (SOEs) can be run quite efficiently, even on commercial bases, confounding the dire predictions of the prophets of public sector doom.

To be sure, unclear and contradictory objectives – e.g., to simultaneously maximize sales revenue, address disparities, generate employment, etc. – often meant ambiguous performance criteria, many open to abuse. Often, SOE failure on one criterion (e.g., cost efficiency) was justified on the grounds of fulfilling other objectives (e.g., employment generation). However, the ambiguity of objectives is not necessarily due to public or state ownership per se.

Problems of coordination among various government agencies and interdepartmental rivalries also played a role.

Some consequences included ineffective monitoring, inadequate accountability or, alternatively, over-regulation.

“Moral hazard” has also been a problem as SOE managements expected sustained financial support from the government, come what may, attributed to weak fiscal discipline or “soft budget constraints”.

Often, SOE managements lacked adequate or relevant skills but were constrained from addressing them expeditiously. But privatization does not automatically solve the problem of lack of managerial skills.

Similarly, privatization of SOEs which are natural monopolies (e.g., public utilities) will not solve problems of inefficiency due to the monopolistic or monopsonistic nature of the industry or market.

Can SOE inefficiency be redressed?

Improvements in SOE management must be required by the national political leadership and can be enabled by increased enterprise and administrative autonomy as well as new incentive systems. Such changes do not require privatization as a prerequisite, but can be achieved by greater decentralization or devolution of administrative authority.

Many SOEs enjoyed monopoly or monopsony powers de jure or de facto, often providing cover for inefficiencies and other abuses. Hence, competition and enterprise reorganization – rather than mere changes in ownership status – are more likely to induce greater enterprise efficiency.

Instead of presuming that privatiza-tion is the only solution, reformers should consider the variety of modes of enterprise reform, privatization, marketi-zation and other measures as options for improving the public sector.

With such an approach, privatiza-tion becomes one among several options available to the government for dealing with the undoubted malaise of many public sectors.

After all, there may well be instances where privatization offers the superior option (e.g., the Hungarian privatization of retail shops), but this should be the policy conclusion after serious consideration of all options available rather than the default option it has become in recent decades.

Remember that many SOEs were set up precisely because the private sector was believed to be unable or unwilling to provide certain services or goods. Such arguments may still be relevant in some cases but no longer relevant in other cases, and perhaps never even true or relevant in yet other cases.

Many SOEs have undoubtedly proven to be problematic, often inefficient. However, privatization has not proved to be the universal panacea for the myriad problems of the public sector it was touted to be.

In many instances, the problem with an SOE is not due to ownership per se, but rather to the absence of explicit, feasible or achievable objectives, or even to the existence of too many, often contradictory goals.

In other cases, the absence of managerial and organizational systems (e.g., flexibility, autonomy) and cultures supportive of such goals and objectives may be the key problem.

Privatization may facilitate the achievement of such organizational goals or objectives with the changes it may bring about in train, but this does not necessarily mean that privatization per se is responsible for the improvements.

In such cases, managerial and organizational reforms may well achieve the same objectives and goals, or even do better, at a reduced cost, and thus prove to be the superior option.

However, the superior option cannot be presumed a priori, but should instead be the outcome of careful consideration of the roots of an organization's malaise. *(IPS)*

Third World Economics, Issue No. 628, 1-15 November 2016, p14

Privatization the problem, rarely the solution

***Third World Network*, December 2017**

Privatization has been one of the pillars of the counter-revolution against development economics and government activism from the 1980s.

Many developing countries were forced to accept privatization as a condition for support from the World Bank while many other countries have embraced privatization, often on the pretext of fiscal and debt constraints.

Privatization generally refers to changing the status of a business, service or industry from state, government or public ownership to private control. It sometimes also refers to the use of private contractors to provide services previously delivered by the public sector.

Privatization can be strictly defined to include only cases of the sale of 100%, or at least a majority share, of a public or state-owned enterprise (SOE), or its assets, to private shareholders.

The definition of privatization in some contexts is so broad that it includes cases where private enterprises are awarded licences to participate in activities previously the exclusive preserve of the public sector.

Why the turn to privatization?

The balance-of-payments problems arising from oil shocks in the 1970s and the US Federal Reserve's raising of the interest rate to well over 20% precipitated sovereign debt crises in Latin America and elsewhere from the early 1980s, forcing many developing countries to seek credit support from the International Monetary Fund (IMF) and the World Bank.

The World Bank and IMF's "neoliberal" policy prescriptions involved liberalization, deregulation and privatization. Collectively, these later came to be known as the Washington Consensus to refer to the common position of three Washington DC-based institutions – the US Treasury, the IMF and the World Bank.

Privatization was advocated as an easy means to:

(1) reduce the "financial and administrative burden of the government", particularly in undertaking and maintaining services and infrastructure;

(2) “promote competition, improve efficiency and increase productivity” in the delivery of public services;

(3) “stimulate private entrepreneurship and investment”, and thus accelerate economic growth;

(4) help reduce “the presence and size of the public sector, with its monopolistic tendencies and bureaucratic support”.

Adverse consequences

Since a significant portion of state-run activities is undertaken by public monopolies, privatization will hand over such monopoly powers to private interests likely to use them to maximize profits.

The privatization of public services tends to burden the public, especially if charges are raised for privatized services which may not improve with privatiza-tion.

Private interests are only interested in profitable or potentially profitable activities and enterprises. Thus, the government will be saddled with unprofitable and less profitable activities, reinforcing the impression of SOE inefficiencies.

Consequently, privatization may worsen overall enterprise performance. “Value for money” may go down, despite improvements used to justify higher user charges.

Privatization in many developing and transition economies has primarily enriched a few with strong political connections who ‘captured’ lucrative opportunities associated with privatization, while the public interest has been increasingly sacrificed to such powerful private business interests. This has, in turn, exacerbated problems of corruption, patronage and other related problems.

Some other adverse consequences of privatization include:

l The social and political implications of having two types of services, i.e., one for those who can afford more costly, private – including privatized – services, and the other for those who cannot and hence have to continue to rely on subsidized public services, such as medical services and education.

l The effects of minimal long-term investments by private owners narrowly focused on maximizing short-term profits.

l Increased living costs as well as poorer services and utilities – especially in remote and rural areas – due to “economic costing” of services, e.g., telecommunications, water supply and electricity.

l Reduced jobs, overtime work and real wages for employees of privatized concerns.

Flawed arguments

Arguments for privatization can be refuted on the following grounds:

l The public sector can be more efficiently run, as demonstrated in Singapore, Taiwan and South Korea.

l Greater public accountability and a more transparent public sector can ensure greater efficiency in achieving the public and national interest while limiting public-sector waste and borrowing.

l Privatization may postpone a fiscal crisis by temporarily reducing fiscal deficits, but the public sector would lose income from profitable public sector activities and be stuck with financing and subsidizing unprofitable ones. As experience shows, the fiscal crisis may even deepen if the new owners of profitable SOEs avoid paying taxes with creative accounting or due to the typically generous terms of privatization.

l Privatization gives priority to profit maximization, typically at the expense of social welfare, equity and the public interest. It tends to adversely affect the interests of public sector employees and the public, especially poorer consumers.

l Public pressure to ensure the equitable distribution of share ownership (e.g., “voucher privatization”) may inadvertently undermine pressures to improve corporate performance since each shareholder would then only have small equity stakes and would therefore be unlikely to incur the high costs of monitoring management and corporate performance.

l With private capital diverted from productive new investments to buying over public sector assets, economic growth would be retarded rather than enhanced. *(IPS)*

Jomo Kwame Sundaram was United Nations Assistant Secretary-General for Economic Development, and received the Wassily Leontief Prize for Advancing the Frontiers of Economic Thought in 2007.

Third World Economics, Issue No. 628, 1-15 November 2016, pp13-14