

# "The Potential Benefits of Privatization, and the Politics"

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## **An essay about the privatization in UK**

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In the last decade, privatization of state enterprises has swept the world. Thousands of state firms from all over the world have gone private. A critical factor behind this move to privatization is the well-documented poor performance of public enterprises. One point of my analysis is the commonplace observation that public enterprises are inefficient because they address the objectives of politicians rather than maximize efficiency. One key objective of politicians is employment: they care about votes of the people whose jobs are in danger and, in many cases, unions have significant influence on political parties. For, example, Donahue describes evidence showing higher employment per unit of output in publicly provided municipal services. The British government for a long time refused to close grossly inefficient coal mines to preserve mining jobs. In this paper, I develop a model of privatization that explains the relative inefficiency of public firms and the improvements of efficiency after privatization, as well as some political issues.

Theoretical arguments for the advantages of private ownership of the means of production are based on a fundamental theorem of welfare economics: a competitive equilibrium is pareto optimal, under certain assumptions (no externalities; the product is not a public good; information costs are low). Privatization, in turn, is a response to the failings of state ownership. Donahue (1989) surveys multiple studies showing the significantly higher cost of public relative to private provision of municipal services in the United States. Lopez de Silanes (1993) documents the inferior profitability of state relative to private firms in Mexico in the 1980s. Mueller (1989) and Vining and Boardman (1992) survey dozens of studies of public and private firms around the world, most of which show that private firms are more efficient. More recent studies have actually shown that efficiency improves after privatization (World Bank, 1992; Megginson, 1994). Private ownership provides a well defined goal that can guide firm policy-profit maximization.

Privatization is regarded as either a purely 'ideological' phenomenon or as I said earlier as a response to the perceived poor performance of state-owned industries. Many governments have

felt the urge to privatize, partly because they were concerned that state-owned industries were becoming a burden: subsidies were mounting, managements were not responsive to consumers and unions were over-powerful. In addition, consumers were dissatisfied and there were constant tensions between government and the management of the state corporations.

On the other hand, governments have many objectives other than profit or shareholder wealth maximization. They can change from one administration to another. This inevitably lead to a reduction of efficiency of a firm's operations and governance. Even if the government does attempt to maximize social welfare, for example, welfare is a difficult thing to measure and use in guiding policy. Additionally the government's goals can be inconsistent with efficiency or maximizing social welfare. Governments are less likely to let a public owned firm to bankrupt so there is little pressure for improvement or efficiency on the managers.

There is another set of reasons for privatization. The use of revenues from privatization to improve government's finance. At the policy level governments around the world have introduced privatization programmes since 1960s, although the results in some countries have been much more successful than in others. In the 1990s, total global privatization receipts are estimated by the OECD to have exceed 936.6 billion dollars, making the planning and implementation of privatization a very profitable activity for international banks and consultancy firms. Privatization has taken a number of forms, from outright sales of state assets, through initial public offerings of shares, to sales to domestic and foreign companies. This helped reducing fiscal deficit in these countries.

Another theoretical reason for privatization is to develop efficiently working markets. Welfare economics argues that efficiency is achieved through competitive markets. If privatization promotes competition, privatization can have important efficiency effects.

In order privatization to be as efficient as possible there should be liberalization and deregulation. The reason for this is that the initially nationalized enterprises are usually monopolies. So some nationally governed monopolies were privatized and turn into private monopolies (gas, water, railways utilities). These monopolistic markets had very big barriers to entry.

Moreover, liberalization and deregulation can proceed independently of privatization. “For example, there may be a degree of liberalization if restrictions on imports are lifted and regulations are removed that had previously hindered competition.”<sup>1</sup>

A number of economic benefits can be expected from the privatization:

\*Change of ownership.-I will start with the citation.

‘what is owned by everyone is perceived to be owned by no-one

So citizens may be told that a corporation is in public ownership but in practice they have no property rights and cannot influence the corporation’s actions. When company is under national control there are not any shareholders so there is no pressure on managers from the market forces and there is no power of exit. So probably managers were concerned with their own interest only. If there were shareholders and capital market, underperforming managers would lose their job. They would be either sacked or their company might be overtaken by another so they became jobless. Efficiency pressures are extremely weak in state-owned company. Since most of these state-owned companies are monopolies in their domestic market it is completely difficult to compare them and assess their performance. Basically, there were not any benchmarks for comparison.

#### \*Depoliticization

Another issue in markets where there are state-owned corporations is politicization, which has implication for efficiencies. First of all government will be held responsible for these enterprises which leads to permanent political influence over the corporation’s management. Lobbying is therefore a constrain for efficiency maximization.

#### \*Liberalization

Market liberalization is that competitive process has efficiency advantage and bring benefits to consumers. One is the power of exit, which put constant pressure on suppliers and producers for improvement since they can easily be substituted. So the dynamic benefits form

competition were great. The key to a market like this is free entry. A move from state to private ownership is usually a necessary condition for significant market liberalization.

Liberalization of industries such as gas, electricity, water, telecommunications and railways, which were in state ownership, would have been regarded as unfeasible or undesirable because they were thought to be natural monopolies. However, one of the principal insights of those who devised Britain's privatization programme, was that it is only the network of such industries (the wires, pipes or rails) which constitutes the natural monopoly element. Production is potentially competitive and so is supply to consumers. So market liberalization and privatization are best seen as complementary policies.

The potential benefits of privatization, especially when coupled with market liberalization, are clear. However, that does not mean that any given privatization programme will realize all or even any of the potential benefits. If we examine the privatization carried out by British Conservative governments we will see that it turned out to be a good example of interplay between government and pressure groups, with relatively little regard for the interest of consumers. This unambiguously proves that political objectives are bound to dominate government actions. One of the main insights of public choice theory is that, between elections, government policies are heavily influenced by producer and other organized pressure groups: hence the observed tendency for policies to be swayed by organized pressure groups rather than by unorganized consumers. Consequently, in any politicized market, organized groups have a powerful incentive to invest in lobbying. An event such as privatization, where major political decisions are being made, provides such groups, both in the industry concerned and in associated industries, with a one-off opportunity to make gain for their members.

The goals which have to be achieved through privatization were: raise of revenue for the state; promote economic efficiency; reduce government interference in the economy; promote wider share ownership; provide the opportunity to introduce competition. However, there are potential conflicts among these objectives, particularly in the sense that actions designed to spread share ownership and to raise large revenues may be inimical to the liberalization of market. Apparently, market liberalization was lowest on the list of government priorities.

Shares of privatized corporations were offered at a substantial discount to initial market valuations. Employees and customers were given special deals and applicants for small numbers

of shares were favoured. By doing this the Conservative Party gained some additional votes. In the 1980s the government believed that privatizing state corporations, whole or with only weak competitors, was best because monopoly privatizations would raise large revenues and be attractive to potential shareholders. Breaking up state corporation at the time of privatization was not favoured. For obvious reason pressure groups wanted to retain their market power after privatization. Managers and unions favoured 'golden share', which restricted the operation of the market for corporate control, hindering potential bidders or takeovers. In other words, Britain's privatization did little initially to liberalize the markets because there was no influential constituency in favour of liberalization. Consumers, who stood to benefit significantly from a facilitation of competition into markets long monopolized, were not sufficiently organized to exert effective pressure. Establishing competitive markets appeared contrary to the interests, not only of politicians, but of all the major interest groups (state corporation management, unions, civil servants). Liberalization was achieved well after the privatization, when new pressure groups emerged (industrial and commercial consumers of the products of the privatized companies), of course with the help of Mergers Commission.

In conclusion, I can say that at the time of privatization politicians pursued the objectives (raising revenues and widening share ownership) which would bring them short run political gains, enhancing their chances of re-election. They left the industry regulatory bodies they had established and Mergers Commission to carry forward the task of liberalization. In addition, privatization schemes will always and everywhere be dominated by political objectives (since they are carried out by governments). It is clear that a move from state ownership, which has numerous inherent drawbacks, to private ownership is potentially very beneficial to consumers. However to ensure that these gains are realized, market liberalization is required as a complementary policy. Even if privatization was not accompanied by initial liberalization, in long run it could result in the emergence of competitive market if there are not barriers to entry. However politics seemed to be more important than the economics and consumer's well being.

<sup>1</sup>C.Robinson: "International handbook of privatization."

## References

1. References: "The economics of business enterprise" M.Ricketts; "International Handbook of privatization" D.Parker; "Privatization: principals, problems and priorities" 'The economic journal' M.Boycko, A.Shleifer, R.Vishny