The Political Economy of Privatisation

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Abstract

This paper examines some of the main arguments relating to the effect of privatisation on efficiency. It is concerned with both narrow economic issues and wider political issues. After a critical examination of some theories, which assert that private ownership is intrinsically more efficient than public ownership, it is argued that for large scale enterprise there are no strong economic reasons for believing in the superiority of private enterprise. As long as the government in question has the will and the power to make a public enterprise function in a socially efficient fashion, the public enterprise may be just as efficient as private enterprise whilst offering additional economic and social advantages.

1. Introduction

During the last decade or so, the question of ownership and economic efficiency and, on a more practical level, privatisation - has become a central issue in policy debate among economists. Privatisation has formed the spearhead of Thatcherite, and other New Right, attacks on the public sector in the advanced capitalist nations. It has also formed an integral part of the economic reforms implemented in many developing countries with the encouragement of the World Bank and the IMF. And following the collapse

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of communism in Eastern Europe and the former Soviet Union - where collective ownership was the dominant form of property - many of the new governments have promised the wholesale privatisation of public assets.

This article examines some of the main arguments relating to the effect of privatisation on efficiency. It is concerned with both narrow economic questions and also wider political issues. By privatisation we mean the outright transfer of public assets to private owners. This is to be distinguished from various reforms, such as commercialisation and corporatisation, which are designed to transform the operation of the public sector whilst keeping ultimate government ownership of the assets concerned. It is also quite distinct from deregulation, which involves the removal of government controls over entry into markets and the conduct of participants. Indeed, as the example of the UK illustrates, privatisation may be accompanied by new, and sometimes tougher, forms of regulation (Vickers 1990). The range of public assets which may be privatised is vast, ranging from housing, small shops through to giant steel works and the like. To cover such a diverse range is impractical, so in this article we shall confine ourselves to the disposal of larger enterprises, whose typical form after privatisation is the joint stock company administered by professional managers. We shall not consider the sale of housing and small enterprises, which following privatisation will most frequently be directly administered by their new owners. Nor shall we consider hybrid forms of privatisation, such as the creation of mixed public-private enterprises or the sale of a minority stake in public enterprise to private shareholders.

The structure of the article is as follows. First we examine and criticise some existing theories which assert that private ownership is intrinsically more efficient than public ownership. We argue that in the case of large scale enterprise there are no strong economic reasons for believing in the superiority of private enterprise. The issue is ultimately a political one, namely does the government in question have the will and power to make public enterprise function in a socially efficient fashion? This takes us out of narrow economics into the realm of political economy. We examine two dimensions of efficiency - static and dynamic - and investigate them from the standpoint of political economy. We conclude that where the state can insulate itself properly against conservative pressures, public enterprise may be just as efficient as private enterprise, whilst offering additional economic and social advantages. The present paper is almost entirely theoretical in character, although some of the evidence related to it is contained in a longer version published elsewhere.[1]

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The residual claimant theory

The most widely known variant of this theory is found in Alchian & Demsetz (1972). According to these authors, modern production is usually organised as team production, and there is a close interdependence among the activities of various members of the team. It is extremely difficult to measure the marginal product of individual team members, so their input of effort must be monitored instead. This is best achieved by appointing a specialised monitor who can ensure that individual members are putting in the maximal amount of effort, i.e. that they are not "shirking". This raises the question of "who monitors the monitor?". A monitor who is merely a paid employee will himself require monitoring and is likely to put in suboptimal monitoring effort. The solution proposed by Alchian and Demsetz is to make a particular member of the team the owner of the firm, thereby assigning to him the residual (or surplus) which is left after paying the costs of production, including the wage of other members of the team. Thus, private ownership ensures that the "monitor", as the residual claimant to the profit of the enterprise, has an incentive to maximise profit, whereas public authorities in the form of the state supposedly do not have such incentive.[2] Hence the superiority of private ownership over public ownership according to Alchian and Demsetz.

As just described, the residual claimant theory may justify the owner-managed firm, but it does not lend much support to private ownership in the form of modern joint stock company. Shareholders in a joint stock company, unlike owner-managers, do not participate in the production process as members of the "team", and are therefore at an informational disadvantage vis-a-vis team members, such as managers, whom they are supposed to monitor. Moreover, even where there exists no such informational asymmetry, individual shareholders of a large joint stock company do not have the incentive to devote time and resources to monitoring the managers, given that any improved performance resulting from their monitoring effort is a "public good", from which those shareholders who do not contribute to such monitoring can also benefit. This point is recognised by Demsetz himself in his later work (Demsetz & Lehn, 1985, p. 1156). Given such a problem of "shareholder collective action", it is not clear whether the residual claimant theory allows us to presume anything at all about the relative efficiency of private firms based on dispersed ownership (Chang & Singh, 1991, p. 17-8).

It is often argued against such criticism that, even though individual shareholders may have little incentive to act as monitors, the stock market will still function as an effective monitoring mechanism (e.g., Manne,

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1965). According to this argument, the initial stage of such "monitoring" will be the "exit" of dissatisfied customers from a badly-performing firm (i.e., they will stop buying from the firm). The result will be falling profitability of the firm, which, in turn, will lead to the "exit" of the shareholders (i.e., the shareholders will sell their shares), causing the shareprice to fall and thereby exposing the firm to the threat of takeover (Singh, 1971, 1975).[3] Thus, the managers will be forced to manage efficiently, even when the shareholders are not personally monitoring them.

The above argument is seriously flawed on the following grounds. First of all, the efficiency of the stock market as a monitoring device depends on the efficiency of the "exit" mechanism in the product market, which in turn depends on the existence of effective competition in this market. Many private firms are monopolies, whose markets are protected by natural and artificial entry barriers, so that customers may not in practice have the genuine ability to "exit". To the extent that customers are captive, profit figures, and hence share prices, may no longer provide a good indication of enterprise efficiency.

Secondly, in the real world, the selection mechanism in the stock market is seriously deficient. (for details, see Chang & Singh, 1991, p. 23-5). Empirical studies show that selection for survival in the stock market is based more on size than on efficiency or profitability. Moreover, on average, the profitability of merging firms does not improve after merger. This implies that, to the extent that the monopoly power of the acquiring firm increases as a consequence of takeover, the evidence is compatible with reduced efficiency in resource utilisation following merger. Singh (1971, 1975) has suggested that instead of disciplining large firms to become more efficient, the market for corporate control may encourage them to seek a further increase in size precisely in order to avoid being taken over, especially by taking over smaller but more profitable firms. Moreover, the takeover mechanism may in a number of ways encourage a "short-termist" outlook on the part of management to the detriment of long-term investment, economic growth, and international competitiveness (Cosh, Hughes & Singh, 1990).

Another weakness of the residual claimant theory is that it is based on the behavioural assumption of pure material self-interest. However, individual material interest is not the only thing which motivates human action (McPherson, 1984). Paradoxically, the existence of quite different motivations may actually be necessary for the residual claimant theory to hold. In the absence of a well-established and efficiently enforced property rights system, the residual claimant would not have the incentive to monitor his

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"team-mates", because his claim could not be enforced. However, no legal system, including the property rights system itself, can function effectively without some degree of moral commitment by the members of society -or what North (1990, p. 55) calls "ideological commitment to integrity and honesty" -because otherwise the enforcement costs would be prohibitively high.[4] In other words, the very existence of an efficient property rights system, which is necessary for the residual claimant theory to hold, depends in practice on some departure from the model of pure self-interest. In the context of public enterprise, motives such as nationalism, altruism, or pride in "serving the public" may be an important influence encouraging managers towards good performance. The conventional assumption of public choice theory (eg Niskanen, 1973), that public sector managers are all self-seeking bureaucrats, is a gross exaggeration. Bureaucratic self-seeking certainly exists and may often be a serious problem, but it is by no means universal. If we adopt this view, it is difficult to explain why there are many excellent public institutions even in situations where they enjoy actual or virtual monopoly power. This is especially true in services like education or health, but it also applies to many industrial enterprises in the state sector (Chang & Singh, 1991). Human motivation is highly complex and it is no more realistic to assume that human beings are driven exclusively by material self-interest, than to assume as many socialists have done that they are driven exclusively by a concern for others.[5]

Is profit maximisation always a good thing?

Most arguments for privatisation assume both that profit maximisation is socially desirable and that private ownership is the best way to ensure profit maximisation. Let us consider the former assumption.

The supposedly desirable character of profit maximisation depends crucially on the existence of well-functioning markets for inputs and outputs. In particular, supplies of inputs and the demand for output must be highly price elastic, and prices must in turn reflect true social costs and benefits. If these assumptions are not satisfied, profit maximising behaviour will not be socially optimal and may even be seriously harmful. One solution, favoured by many economists, is for the government to correct such market failure by imposing taxes and subsidies so that the prices paid and received by firms coincide with true social costs and benefits. This will ensure that profit maximising firms do what is socially desirable. However, such a text book solution may impractical, either for political reasons or because the government may lack the information and administrative capacity required to set up and run what may be a highly complex tax and subsidy regime. The alternative is then either to ignore anti-social forms

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of profit maximising behaviour or seek to control them directly by means of government regulation and/or public ownership.

Examples where profit maximisation may be anti-social are legion. Natural monopoly is the most obvious case. Profit maximisation in this case may lead to a high level of internal efficiency (X-efficiency) since it may be in the interest of a monopolist to reduce costs. However, it is also in the interest of such a monopolist to restrict output and force up the price to consumers. The result will be a sub-optimal level of production and a possibly undesirable redistribution of income from consumers to the owners and employees of the firm concerned. This danger is widely recognised by economists.

Another situation where profit maximisation may be anti-social is that of mass unemployment. Under these conditions, the wage rate which firms must pay is likely to be much greater than the opportunity cost of labour. In this case, profit maximising behaviour by firms will lead to a suboptimal level of both employment and output. One solution might be to cut wages, but this may be politically impractical and socially undesirable. In an oligopolistic economy, it may even be counterproductive, since the result of lower real wages in such an economy may be a general decline in effective demand and even more unemployment. Another solution might be to subsidise employment so as to bring the private cost of labour into line with its social cost. However, such a scheme may be politically impractical or administratively very difficult to operate. If, for whatever reason, the private cost of labour to the firm is higher than its social cost, profit maximising behaviour will lead to suboptimal employment and output. Paradoxically, supposedly "inefficient" practices, such as "overmanning" or keeping open unprofitable plants, may actually be socially efficient. They may result in more total output in the economy than would be the case under pure profit maximisation. This is an obvious point, but it is widely ignored by those who assert that the low profitability of certain public enterprises is irrefutable evidence of their inefficiency.

These are only two examples of where private profit maximisation may lead to socially inefficient outcomes. There are also numerous examples associated with externalities on the output side. For example, a public enterprise may supply cheap services to some infant industry or it may spend a considerable amount training workers who will then leave to join other firms. Theoretically, all of these services could be paid for explicitly by the government or by their private beneficiaries, in which case profit maximisation by the enterprise concerned would be socially efficient. But explicit payment may be impractical for political or informational reasons, in which case profit maximisation will be socially inefficient and lead to a suboptimal supply of the relevant output.

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Thus, there are many circumstances under which profit maximising behaviour is socially inefficient. Under conditions of monopoly, mass unemployment or significant externalities, such behaviour may lead to suboptimal levels of output either now or in the future.[6] Where this is the case, the profit maximising proclivities of private enterprise may be a social disadvantage, and not an advantage as its supporters claim. A well functioning "mixed" economy must, of necessity, be based on profit seeking behaviour by the majority of enterprises, for without such behaviour the market loses its character as a coordinating mechanism and generator of information. But such behaviour is not universally desirable on the part of every single enterprise, and the number of exceptions is sufficiently large to undermine the automatic presumption that private ownership is beneficial simply because it encourages profit maximisation.

The dispersed knowledge theory

According to the Austrian School, the nature of human knowledge - including economic knowledge - is such that it can never be fully codified and transmitted to others (Hayek, 1949). Given such limited transferability of knowledge, the state is always more ignorant than individual private owners, as far as the latters' own business is concerned. The failure of central planning, according to this view, is the ultimate proof of the difficulty of centralising dispersed knowledge through a hierarchical system (Lavoie, 1985). Decision-making will, therefore, be more efficient if it is left in the hands of private owners and their agents. Hence the superiority of private over public ownership.

This argument is open to several objections. First of all, the difficulty of utilising dispersed knowledge is ubiquitous, and is not just confined to public enterprise management or other types of state control or intervention. The same problem exists to a similar degree for any large private enterprise, be it multinational or purely domestic in operation. Nevertheless, large private organisations do exist and often function well, at least partly because they have certain other informational advantages - for example, economies of scale in information provision or the importance of knowledge embodied in organisational rules and routines. In addition, they may also have advantages of scale and scope in both production and distribution. All these advantages are equally available to large public enterprises. The real question is what is the ideal mix of decentralised and centralised forms of knowledge utilisation -that is, between spontaneous interaction among independent units through the market and hierarchical interaction within one organisation. And this is primarily a matter of optimum size rather than the ownership.

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As the Austrians correctly emphasise, competition, or what they call "rivalry", plays an important role in the generation of the information necessary for effective coordination (Lavoie, 1985; Tomlinson, 1990). However, this is, strictly speaking, not an argument for universal private ownership (Rowthorn, 1990). Product market competition, if effective, will generate the same information regardless of who owns the enterprise concerned. Hence the argument for "letting the market decide" is not a justification for private ownership *per se*, but for effective product market competition combined with a "hard budget constraint" on the enterprises involved, be they public or private (see below for a more detailed discussion of the question of budget constraint).

There are many situations where greater product market competition may increase the efficiency of public enterprises. First of all, competition may come from other public enterprises. For example, in the UK, following deregulation in the early 1980s, the state-owned bus company, National Express, competed vigorously in the area of long distance transport with the state-owned railways (Vickers & Yarrow, 1989, p. 322-5).[7] Secondly, competition may come from domestic private firms. The good performance of the Italian publicly-owned steel-maker Finsider and the French auto-producer Renault for the last few decades can at least partly be explained by the rather fierce competition from domestic private firms (Ayub & Hegstad, 1986, p. 18). Thirdly, competition may also come from competitors in the export market. The examples here include CVRD of Brazil (iron ore), OCP of Morocco (phosphates), ICL of Israel (chemicals), HMT of India (machine tools) (Ayub & Hegstad, 1986, p. 18).[8] Lastly, import liberalisation may be another way of increasing competition, although for developing countries, this is a limited option, since many of the enterprises exposed to such competition are "infants" and may therefore not be able to withstand it.

Summary

In this section, we have argued that existing theories do not provide a case for universal private ownership. However, even though private ownership is not universally superior to public ownership, there will be cases in which this is true and in which privatisation is the appropriate solution. For example, the state may lack a particular capability which is available to some firm in the private sector. If the state cannot acquire this capability at reasonable cost, privatisation may be the only feasible course. For example, a foreign multinational may have superior technology, managerial skills or access to markets, but is not willing to collaborate in joint ventures with the state sector or to administer state enterprises on a contractual basis, or else

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the terms for doing so are unacceptable. In such a case, the best course may be to hand over the relevant activities to the multinational in question.

This is only one example amongst many. Such examples do not depend on any intrinsic superiority of private ownership, but on the specific capabilities possessed at any given time by the private and public sectors, and on the ability of the public sector to acquire new capabilities on a realistic time scale. A decision by the government to hive off or leave some particular activities to private enterprise is no different from that of a private company choosing to limit the range of its activities to what it can most effectively manage. It is simply a matter of portfolio choice. The capabilities of the public sector depend on its past history and must be taken into account when deciding the optimum boundary between private and public sectors. As far as large-scale enterprise is concerned, there is no activity which the public sector cannot in theory perform as efficiently as the private sector. Therefore, in the case off large-scale enterprise, the decision where to draw the boundary should not be based on general principles concerning the superiority or otherwise of private ownership, but on a case-by-case appraisal of the actual and potential capabilities of the public sector. Each case should be decided on its merits with no presumption that private ownership is intrinsically superior.

2. Political Economy or Ownership?

We have argued above that it is difficult to claim, on purely economic grounds, that private ownership *per se* will guarantee better enterprise performance. The residual claimant theory and the dispersed knowledge theory are great improvements on the traditional Neoclassical analysis, where ownership does not matter for efficiency.[9] This is because they take the "social" nature of the economic process more seriously. The residual claimant theory focuses on conflicts of interest in the production process and warns us against the danger of viewing production as purely an engineering process. The dispersed knowledge theory sees economic co-ordination within and between decision-making units as a "social" process, where the form of interaction matters because of the problem of knowledge transmission.[10]

Despite its obvious merit, the residual claimant theory does not provide much support for the proposition that private ownership is intrinsically more efficient than public ownership. On the contrary, as the predominant shareholder, the government can exert more control over the management of a large public enterprise, than could the dispersed shareholders of an

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equivalent private joint stock company. Thus, the government can overcome the shareholder collective action problems which undermine the residual claimant theory in the case of joint stock companies. However, this is only one aspect of the problem. It assumes that the government will always act in accordance with the public good, in particular that the government will always use its power to compel public enterprise to be efficient - whatever that means a particular context. The recent vogue for privatisation reflects a disillusionment with government, with both its motivation and its ability to acquire the information required for monitoring public enterprise. The question of motivation is, of course, central. When nationalisation was in vogue, it was taken for granted that the state was an effective guardian of the public interest and would use its power to make public enterprise perform efficiently. The pendulum has now swung in the opposite direction. It is now widely assumed that states are universally corrupt or weak. They serve the interests either of government ministers and the bureaucracy, or else those of particular consumer and producer groups, especially the employees of public enterprise itself. They either interfere harmfully in the operation of the public sector, or else they shield this sector from competition and subsidise its inefficiency. The failings arising from the side of government are assumed to be normally more harmful than those arising from private ownership. From this perspective, private ownership is a second best solution. With an honest and strong state, public ownership might be superior, but given the deficiencies of any actual state, private ownership is better.

The second best argument for privatisation is an interesting argument which may well be correct in particular cases, but it is not sustainable as a general proposition. There are too many exceptions for it to be taken even as a working hypothesis that public ownership is normally inferior to private ownership. There are numerous examples of highly efficient public enterprise and of situations where governments have put considerable pressure on public enterprise to improve its performance. However, despite these numerous exceptions, the second best argument for privatisation does have a certain merit. It takes the discussion of efficiency beyond the narrow realm of economics into so-called "political economy", which takes explicit account of the political factors which influence government economic policy and its treatment of public enterprise.

Before discussing the politics of public enterprise efficiency, we should point out that there exist two concepts of efficiency in the economic literature: static and dynamic. Static efficiency is loosely defined as efficiency in the use of existing resources, whereas dynamic efficiency is loosely defined as efficiency in the generation of new resources through

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sustained innovation and structural change. In the literature on public enterprise and privatisation, as in other conventional economic literature, the uncharted waters of dynamic efficiency are pretty much deserted and the discussion is usually confined to the problem of static efficiency in the form of "budget constraint". However, dynamic efficiency deserves more attention, as is increasingly recognised even by economists of more orthodox persuasion, who have conventionally concentrated on static efficiency (see Helm *et al.*, 1991, and Newbery, 1992, for some examples).[11] In the following discussion, we approach the question of public enterprise efficiency from these two angles.

Static efficiency: budget constraint

The most common argument against public ownership is based on the notion of "soft budget constraint" as proposed by Kornai (1979). The argument, briefly, is that public enterprises, especially in socialist countries where the state has a large room for manoeuvre for its budget, do not have the incentive to economise on resources because they have access to almost unlimited finance from the state - that is, they face a budget constraint which is not binding enough. How does this relate to the question of political economy?

Think of a situation where a public enterprise is inefficient simply because it receives open-ended subsidies from the state and has therefore no incentive to improve performance. The simplest and cheapest solution to this particular problem is to follow the example of Margaret Thatcher in the UK in the early 1980s and establish a "hard budget constraint" by abolishing or limiting subsidies. This is more efficient than privatisation because it avoids the transaction costs incurred by the latter policy (e.g., costs for valuation, flotation of the shares, risk premium, etc.). However, under certain conditions, the imposition of a hard budget constraint by the authorities may be *politically* impractical, because of the opposition from those affected - for example, the managers, workers, and consumers or even other firms who were previously getting their goods at subsidised prices.

In this case, privatisation may be the most effective option. With the enterprise in public hands the state may find it impossible to resist demands for subsidisation. However, with the enterprise in private hands, the political pressures for subsidisation may be greatly weakened, and the enterprise budget constraint correspondingly hardened. By privatising the enterprise, the state is in effect "abdicating" responsibility and thereby insulating itself from interest group pressure (on the theory of "abdication" of power, see Schelling, 1960, ch. 1; Elster, 1984, p. 411-22).[12]

One must recognise why privatisation is the superior option in this example. It is not because of any intrinsic or universal superiority of private

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over public ownership. It is entirely because of the politics of state intervention in the particular case concerned. There will normally exist technically feasible incentive schemes which, in theory, could ensure that public enterprise functions as efficiently as private enterprise - or even more so from the social point of view, because of externalities and distributional considerations (see Kaldor, 1980, for a more extensive discussion). The problem is that such incentive schemes may be impractical due to political obstacles. In a situation where the ability of the state to enforce its desires is politically constrained, or where the state itself has been "captured" by conservative interests, privatisation may be a way of approximating an outcome which is technically feasible but politically impractical under public ownership. It is no coincidence that the public sector has been efficient in countries like Korea, Taiwan and France, where states have been more 'autonomous' from conservative interest group pressures, and therefore more able to impose a hard budget constraint.

Dynamic efficiency: structural change

Dynamic efficiency refers to the ability to generate new resources, in contrast to the good use of the existing resources, which is static efficiency. Outside the fictitious world of steady state growth, any dynamic economy will go through a series of structural changes. Is there any reason to believe that public enterprises are less capable of achieving such transformation?

Structural change, by definition, involves the transfer of resources from old to new sectors. Such a transfer is not an easy task when the physical and human assets involved are "specific" in the sense that their redeployment brings about a reduction in their values (on the notion of asset specificity, see Williamson, 1985). Such specificity makes the owners of these assets reluctant to accept uncompensated change because of its negative impact on their incomes and wealth. In most cases, the protection of inefficient firms and industries, be they privately or publicly owned, is the result of the political resistance to change by the owners of specific assets whose values are threatened by the change.

It is not only agents in the public sector who can block structural change, but also private sector agents, because what matters here is political influence and not ownership *per se*. As wealth and numbers are important in politics, the owners, managers, and workers in large firms are bound to exert a political influence over the process of structural change, be these firms private or public. In an era of massive structural change, like the 1930s and the 1970s, few states are strong enough to resist pressure to subsidise those who are going to lose out in the process or even to take over ailing large private firms (Ayub & Hegstad, 1986, p. 58). This is testified by the fact

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that many recent state takeover or rescue operations of large private companies have occurred under political regimes professing ideological allegiance to free market and private ownership - witness the Chrysler rescue operation by the Republican government in the USA and the nationalisation of the shipbuilding industry in the late 1970s in Sweden by the first non-socialist government since the 1930s.

Not only there is no *a priori* reason to believe that public enterprises are worse at structural change than private enterprises, they may actually be a better vehicle for structural change under certain circumstances. In a world where the capital stock is "interdependent in use but divided in ownership" (Abramovitz, 1986, p. 402), consolidated state ownership may allow a better coordination of individual firms" decisions to adapt their capital stock to changing technologies - or, in other words, to internalise externalities arising from the discrepancies between the patterns of interdependence and the patterns of ownership due to technical change.[13] If public enterprises are worse at structural change than private firms, this will be primarily because the state is, for one reason or another, less able to confront the resistance from potentially redundant managers, workers, and others related to the public enterprises concerned (e.g., suppliers, consumers) than would be the case if these enterprises were private.

Ownership is relevant to the question of structural change partly because it may affect the ability of producers and other relevant interest groups to block necessary change. It is assumed by the more dogmatic advocates of privatisation that conservative interest groups normally have more power in the case of public ownership than private, but this is frequently not the case. Indeed, nationalisation has been used in the past specifically to overcome conservatism on the part of private firms, and to promote the restructuring of industries dominated by a multiplicity of inefficient producers. More generally, public enterprise has been used, in countries like Meiji Japan, to establish a national presence in sectors where private firms are unwilling to enter because of unfamiliarity or too much uncertainty.[14] The truth is that, as far as structural change and innovation are concerned, there is no single form of ownership which is optimal under all conditions. It all depends on the particular circumstances.

3. Conclusion

In this paper, we have criticised some purely "economic" arguments for privatisation. In our view, the question of public enterprise efficiency cannot be divorced from politics. Such efficiency depends on the attitude of the state towards issue like competition and budgetary policy, which in

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turn depends, above all, on the ability of the state to insulate itself against conservative pressures from both inside and outside these enterprises. Where the state can insulate itself adequately, public enterprise may be every bit as efficient as private enterprise, whilst offering additional economic and social advantages. Where the state cannot so insulate itself, privatisation may well lead to greater efficiency, but this cannot be taken for granted since the same conservative forces previously at work under public ownership may continue to influence state policy even after privatisation. Even where the performance of public enterprise is inadequate it may be quite feasible to improve it without privatisation, thereby retaining the traditional advantages of public ownership, whilst avoiding the considerable transactions costs and regressive income redistribution often associated with privatisation. In the case of large enterprises, privatisation should normally be a last resort to be used only when there is no other way to achieve an acceptable gain in performance. It should not be used simply as a source of funds for cash-starved governments. Nor should it be done for purely ideological reasons or as a bribe to some particular fraction of the electorate. In the case of domestic housing and small business, the argument for privatisation is much stronger. We have not considered this case in the present article, so it would be inappropriate to discuss it here. Suffice it to say, that even in this case there is often more than one option, and the outright sale of assets may be inferior to some alternative such as leasing or franchising. As always, the choice should be made on pragmatic and not ideological grounds.

Notes

1. This article is an extended and heavily revised version of Chang and Rowthorn (1992). An earlier draft was presented to a conference on privatisation organised jointly by the Social Policy and Public Sector Research Centres of the University of New South Wales. The final draft was written at the WIDER Institute of the United Nations University in Helsinki. The present article is almost entirely theoretical in charcter, but a longer version containing empirical evidence is available in monograph form.
2. One related argument is that the team member whose activity is most difficult to monitor should become the owner, since this will minimise monitoring costs and hence maximise efficiency.
3. *On the concept of "exit" and the distinction between "voice" and "exit" as* disciplining mechanism, see Hirschman (1970).
4. Similarly, Simon (1991) points out that no organisation of reasonable size can function without the members developing some oragnisational loyalty - because otherwise the monitoring costs will be too hight. And if there is a certain tendency for organisational loyalty to develop, making the members of an organisation conform to the organisational objectives is probably less important than defining

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the objectives. When the organisational objectives are not clearly defined, the members tend to define them in their own ways, if not in ways to suit their own personal intersts. And, as often pointed out in the context of public enterprises, the lack of clarity in the objectives is one reason behind their inefficiency (see Chang & Singh, 1991).

5. Even in private capitalist enterprises, many employees exhibit altrusitic motivations such as group loyalty or ethical concern for the general public. Sometimes these motivations are beneficial to the firm, because they reduce mojnitoring costs and ensure a better service for customers at no extra cost. And sometimes the opposite is the case, when employee solidarity or external altruism conflict with the profit-seeking aims of the firm.
6. Under these conditions, obstacles to profit maximisation, such as resistance from the trade unions, may actually be socially efficient and increase the overall level of output or growth in the economy. This is not always the case, but it is more frequent than many economists seem to recognise. It is especially relevant in judging the performance of public enterprise. Many of the indicators used to compare the performance of private and public enterprise are defective, because they ignore or make inadequate allowance for the existence of market failure. Where there is significant market failure of any kind, such indices of performance as profitability or labour productivity may be seriously misleading. And encouraging public enterprises to maximise profits, or privatising them so as to achieve this end, may be damaging to the economy as a whole.
7. National Express has since been privatised for no good economic reason.
8. Korea's state-owned steel mill, which is among the most efficient in the world, provides another good example (Amsden, 1989, ch 12).
9. As pointed out by Lavoie (1985), the "socialist" models of central planning, like the Lange-Taylor model, were fundamentally Neoclassical in this sense.
10. For a more generalised critique of Neoclassical view of human rationality, see Simon (1983).
11. One important point to note is that there may be a clash between the pursuit of static efficiency and the pursuit of dynamic efficiency. As Schumpeter (1987) noted, monopoly, which reproduces static inefficency in the form of deadweight loss, may (but may not) encourage dynamic efficiency by promoting innovation.
12. Deregulation and trade liveralisation, in certain contexts, may also be regarded as attempts by the state to abdicate itself from power and reduce the scope for private sector pressure on economic policy-making.
13. This does not mean that we necessarily need public ownership for such changes. For example, conglomerates perform a deegree fo this coordinating role in countries like Japan and Korea - of course, with a lot of state intervention if not state ownership - and the banks do it in countries like Germany.
14. For a defence of public enterprise in this context see Newbery (1992)

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