

Justifying Global Privatization: Economics, Public Policy, and Education

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Introduction

Privatization is a global phenomenon – a form of economic restructuring which in its modern form has been most broadly exemplified by the economic policies of the Thatcher Government in Britain during the early 1980s. Since then, privatization has spread rapidly in Australia, New Zealand, Eastern Europe, Sub-Saharan Africa, South America, and to a lesser extent in Canada and the United States. By 1992, there had been 15,000 sales globally, the vast majority of which were in Eastern Europe. Currently, more than 100 countries have ongoing privatization programs. And, in 1997, US\$153.4 billion in transactions occurred (OECD, 1998).

While extensively undertaken as part of a global movement toward a market orientation, privatization as a matter of government policy is far from uncontroversial. As Graham (1998) comments, “There is little agreement about how to reform public institutions or what the role of the state versus the private sector should be (p.1).” While activity is growing among OECD members, “most industrial countries still maintain substantial public sector assets, despite the burden of public sector deficits” (Pitelis & Clarke, 1993, p.7). And, according to a World Bank (1995) report, even though there is an increasing international agreement that the private sector can generate superior performance results in privatized entities, “state-owned enterprises (SOEs) account for nearly as large a share of economic activity in the developing world as they did twenty years ago” (p.1). The report goes on to say that “although the potential gains from privatization and other reforms are substantial, only a few countries have reformed their SOEs successfully” (p.2).

Privatization programs can run into difficulties for many reasons: lack of political will, low levels of public acceptance, unavailability of capital, absence of appropriate expertise, and so on. But there are serious debates about the fundamental issue of whether privatization is justifiable at all. On the affirmative side are arguments contending that share ownership provides the necessary incentive to efficient performance. Bureaucrats do not have this incentive in SOEs; indeed, they are motivated by status (e.g., large offices and many employees) and this leads inevitably to economic inefficiencies. As well, it is claimed that economies are more efficient overall when there are many private corporations. And, at the political level, government can be improved by having fewer entities to manage – especially if the private sector can handle them better. Opponents counter that economic dynamism in an economy has less to do with ownership than who

has political influence or control over policy making (Rowthorn & Chang, 1993). Others hold that privatization leads to many harmful consequences. Employees can expect lower wages and unsafe safe working conditions, that is, if they keep their jobs after the inevitable restructurings. The public has good reason to worry about such things as a lack of concern by the private sector for the environment. Equally, consumers risk higher prices, poorer quality and lower product safety (Canadian Union of Public Employees, 1999). As Graham (1998) notes, “regardless of the actual trends, in many regions there is a broadly shared *perception* the market reforms are to blame for increased poverty and inequality (p.3).”

In this paper, I want to address the issue of whether or not privatization is justifiable in a universal sense. In other words, is there a line of argument that is applicable to any country, developed, transitional, or developing? Although there are many arguments put forward by economists, public policy experts and governments, because of space limitations I intend to consider only two. Together, both make a strong case for privatization; and their conclusions are central to many of the other lines of argument. The position I will take in what follows is that they cannot in principle be successful. Whether any justification could be universal, and what it would take for it to be so, remains for a future investigation.

In structure, the paper will begin with an outline of the meaning of privatization, the forms it can take, entities which typically can be candidates, and a number of the ways in which privatizations are done. Second, I will give some commonly used justifications for privatization programs. Third, two arguments from this list that provide good cases for privatization will be critiqued. Finally, I will close with an observation on the importance of education to privatization.

The Nature of Privatization

Privatization is a form of macro-economic restructuring. It is a transformation from state-controlled economic activity to that of the private sector. And, it results from a government policy. This is unlike, say, the Industrial Revolution, which was an evolution from one form of economic activity to another.

There are many forms that privatization can take. Commonly, it is understood to be the conversion of a state-owned enterprise into a share capital corporation and the sale of at least 50% of the shares to the private sector. This can be accomplished by auctions, negotiated sales, IPOs, MBOs, stock distributions, increases in the underlying capital base, vouchers, deposit receipts, and so on. However, the concept of privatization is much broader. Beesley and Littlechild (1997) correctly point out that “the underlying idea is to improve industry performance by increasing the role of market forces. Many other measures can contribute to this...(p.26)”. Deregulation of an industry (such as power production), to reduce the barriers to entry of private sector competitors is one alternate approach. Selling the assets of state enterprises, long-term leases or concessions, joint ventures and management contracts are others. Clearly, only some privatizations entail a change in ownership, but all of them involve a transfer of control. So, that is what we will speak of as being central to its nature.

In addition, the range of candidates for privatization is broad. Over the past two decades we have witnessed the transfer of control to the private sector of manufacturing companies, oil & gas producers, retailers, service firms, financial institutions, infrastructure (e.g., highways, bridges), railroads, airlines, airports, sea ports, schools, courthouses, prisons and even government pensions.

Arguments to Justify Privatization

Any attempt to justify privatization ultimately backs into the question of whether market capitalism itself is justified. One might try to avoid this by saying that a form of privatization could be achieved by selling state-owned businesses to private individuals where there is not a market economy (i.e., as in the Middle Ages).¹ But this would miss the real purpose of modern privatization programs, namely to reduce the role of the state and move toward market economies. Should we therefore be addressing the issue of market economies head on? This is one of the fundamental problems of political economy, and it would be far beyond the scope of this paper to deal with it adequately. However, bye-passing this issue does not avoid the need to provide a separate justification for privatization. For there are often public policy reasons for legitimately wanting the state to retain control of entities which are strategically important to the economy even if the market place exists for privatizing those businesses. Health, education, transportation arteries, and telecommunications are examples. So, it is important for us to consider the case for privatization in its own right.

How, then, can privatization be justified? Over the past 20 years, governments have put forward or accepted a wide variety of arguments. First, the financial condition of government can benefit. The proceeds of enterprise sales can result in much needed capital for debt reduction or investment elsewhere in the economy. As well, the transfer of control to the private sector can release the government from regular operating subsidies or from incurring future capital expenditures for maintenance and upgrading.² Second, government efficiency can be improved. The broader the scope of government activities the more difficult and costly it is for a government to manage them. It requires a very large bureaucracy and considerable time and effort on the part of government members to provide policy direction. Privatization of entities that do not, or no longer, serve important public policy objectives can improve the efficiency of government by enabling it to be more focused on issues of key importance (Jorgensen & Hafsi, 1993). Third, privatization programs may be justified by virtue of collateral benefits to the state. For example, in some cases, membership in the World Trade Organization or being granted World Bank loans require that governments adopt privatization policies (Pitelis & Clarke, 1993). Fourth, private, rather than public, sector companies are more likely to succeed in the highly competitive global marketplace given their orientation toward competitiveness and risk taking (Pitelis & Clarke, 1993). Fifth, there can be significant benefits to individuals in situations, for instance, where vouchers or stock is distributed or sold at a discount to employees of entities being divested. In Britain, one important objective of privatization was to widen the distribution of shareholdings and to affect a re-distribution of wealth (Vickers & Yarrow, 1989). As well, a shareholder culture

promotes reduction of personal dependency and encouragement of entrepreneurship. Sixth, significant market efficiencies can result from having more listed companies on stock exchanges. This encourages greater liquidity overall because investors have more choices. Improved liquidity, in turn, benefits the listed companies by improving their access to capital. Seventh, is a justification known as the dispersed knowledge theory whose founding father was F. A. Hayek. Being competitive in a business depends upon each entrepreneur's knowledge – most especially in the form of understanding price signals in the marketplace. Entrepreneurs filter these signals through their own unique knowledge and experience, and they look for unfilled gaps for new products, services or production efficiencies. By his or her proximity to the locus of business decision making, the entrepreneur has access to competitive knowledge that government can never have because it is too remote. In other words, competitive knowledge is disbursed throughout the economy, and it is too complex and time sensitive for government to be capable of using. Government run companies can therefore never be as competitive as those in the private sector.³ Eighth, is the property rights, or residual claimant, theory which holds that the private sector is necessarily more efficient than the public sector. Over time this generates greater economic output, wealth, and employment. Further, it benefits consumers in the form of greater product variety and lower prices. Ninth, the public choice theory maintains that privatization is justified because government bureaucrats, and those who manage state-controlled businesses, are motivated to act in ways that promote the opposite of efficiency and value enhancement.

As indicated at the outset, space limitations will not permit us to evaluate all of these purported justifications. Consequently, I propose to focus on eight and nine above, namely the property rights and public choice theories which are complementary views that together make the case that the private sector is more efficient than government. Restricting our examination in this way is appropriate for three reasons. First, privatization is a public policy decision to restructure government and enhance economic development. Because of its economic nature, if we were convinced that, on balance, the private sector would be more capable than government of producing the economic benefits claimed by the theory, we would have a powerful basis for supporting privatization. This does not mean that other considerations such as public welfare are not important. Rather, it is to say that without an economic grounding, there would be no possible justification.

Second, with the exception of the disbursed knowledge theory, the arguments supporting private sector efficiency and deriding its public sector counterpart are different than the other kinds of argument for privatization. The efficiency-based arguments seek to explain why it is necessarily only the private sector that can perform in ways beneficial to the economy. The other arguments are contingent, hence circumstances might be such that their alleged benefits do not come about. For instance, selling a state-owned entity may actually cost money, not provide cash for debt reduction or infrastructure investment. Or, the international agencies may change their policies favoring privatization.

Third, the notion of private sector efficiency underlies the value in each of the other forms of justification. The viability of moving government owned entities off the public purse depends upon the superior ability of the private sector to generate surplus cash. And, if there is any substance to the claim that private sector corporations are likely to be better international competitors than publicly controlled entities, it is because of private sector performance efficiencies. In addition, enabling government to focus on priorities by reducing the number of enterprises requiring bureaucratic and political attention makes sense only if the private sector is as good or better than the public sector at operating these entities. Finally, the disbursed knowledge argument is valuable only if efficiency is the result. So, to provide an explanation showing that the private sector would be more efficient than its public sector counterparts, would go a long way toward sustaining the plausibility of the other arguments.

Let us now consider the two main theoretical arguments to support the private sector efficiency justification: the property rights and public choice theories. As indicated at the outset, my objective will be to answer the question, could these arguments lead to a universal justification for privatization?

Property Rights

There are variations on property rights (PR). Two streams of the theory are economic and legal. The former are entitlements under statute. Economic rights, however, relate to the actual benefits – i.e., those entitlements we have to consume the benefits of an asset either directly or indirectly through transferring it (Barzel, 1997). We will be concerned with the economic, rather than legal account.

The theory maintains that there is a difference in performance between private and public companies and that this derives from the ownership arrangements (Tittenbrun, 1996). Share ownership provides an economic incentive. Owners are entitled to claim the earnings, sell the shares and transform the company's assets. These entitlements provide an incentive to produce or demand a higher level of performance than would be the case if ownership were in the hands of the state. Classical economics takes the firm as its unit of analysis. By contrast, PR focuses on individual decision-makers and assumes that each will maximize his or her own utility within the rules of property ownership.

A problem that PR must address arises when the owner engages management as its agent to operate the company. The interests of management may not align with those of the owner. Management, after all, may be focused not on enhancing the value of the company's shares but on having a high salary and corporate perquisites such as large expense accounts, club memberships, a company car, and so on. So the owner incurs "monitoring costs" to ensure that his or her interests are being looked after. This entails having regular financial reporting, audits, and a governance structure. The problem is worse when the company's shares are widely held. Individual owners then become further removed from direct control over the daily affairs of the company and from management, hence, the monitoring costs are higher.

PR has a response. The most direct means of aligning owner/manager interests is to compensate management at least partly in shares or options. The manager becomes an owner. But there are other ways of focusing the attention of management. For one thing, managers have a reputation to uphold in the job marketplace. Managers do change jobs and getting an improved situation is heavily dependent upon how well they performed (for the shareholders) in their previous position (Fama, 1980; Tittenbrun, 1996; Zeckhauser & Horne, 1989). As well, there is monitoring that occurs within the company. Superior officers monitor those more junior; and ambitious subordinates provide their seniors an incentive to perform or risk being replaced by them (Pitelis & Clarke, 1993; Tittenbrun, 1996).

In PR theory there is a further element of control over management, namely the capital markets (Rowthorn & Chang, 1993; Tittenbrun, 1996; Zeckhauser & Horn, 1989). Poor management policies will result in lower performance levels and thereby a fall-off of customers and ultimately a decline in share price. Managers who hold shares will suffer. And the company could become a takeover target, one result of which could be a change in management. The bond markets also have a monitoring role. If the corporation's performance weakens, bond ratings will decline. This lowers the value of the company's debt. And, it also can signal trouble to the equity markets with the same result as mentioned above.

The PR school makes a powerful case to support privatization. In a privately held company there is a greater incentive to operate efficiently and profitably because owners can receive dividends and benefit from the market's perception of the company's future profitability by selling the shares. Of course, precisely the same arguments as those given above can be turned against state-owned entities. If they are profitable, the benefits are spread so widely over the public as a whole, the incentive component is meaningless. And, there are no transferability rights, i.e., rights to sell shares. So the motivation to grow the company's future wealth is limited.

Critique of the Property Rights Thesis

To begin with, a note should be made about the scope of PR as a justification. We pointed out earlier that privatizations can take the form of share sales in various forms, asset divestitures, long term leases, management contracts, partnerships, and other types of joint venture. PR deals principally with transferable ownership. To use it as a justification for the wider family of privatizations we would have to limit PR to those situations in which there is ultimately private sector ownership. For example, a lease or management contract could be justified by PR, but only to the extent that the lessors or contractors are private sector companies.

That said, the PR school of thought has intuitive plausibility. To be sure, people will do things for which there is an incentive. But is the theory strong enough to justify privatization? I think it is an important component of an adequate justification; but it has gaps that make it insufficient on its own.

The right to residual cash flow. How broadly available are the enticements of share ownership? Consider the residual claims. First, in the case of a single owner, the benefits are under his or her direct control. However, in a widely held corporation the board of directors establishes dividend policy; individual shareholders may have little impact on this. A shareholder whose personal financial circumstance requires a high level of dividend income may find that a decision by the board to lower the dividend payout ratio significantly reduces the incentive provided by the right to a residual claim. Second, suppose the tax laws favor dividend income rather than capital gains: the value of the incentive would be lowered because of the board's decision. Third, the tax laws in certain jurisdictions are so onerous that the relative incentive value is lower than in a more lenient tax environment. Fourth, there could be a circumstance in which an employee received a very high proportion of his or her compensation in stock options. If a greater cash income for living expenses was required, private ownership for that individual might provide less of an incentive than working for a government agency which paid a higher salary.

The point is that PR focuses on ownership and makes assumptions about its motivating value. But, incentives are dependent upon one's personal situation. Residual claims will vary, even be nullified, in certain circumstances. So it is wrong to say that residual claims necessarily function as an incentive.

Right to sell the shares. If a company is privatized, each new owner will have as an incentive the right to sell the shares. But, this prospective benefit may in fact not be available. For one thing, there could be a restriction on transfer of the shares – i.e., standstill agreements or “quick flip” provisions with former shareholders which prevent on-selling of the shares for some specified period of time. Or there could be “clawback” provisions which impose a penalty if the shares are sold at a profit before to a certain date in order to prevent the new owner from reaping a wind-fall because of a change in market conditions soon after the share purchase has occurred. Further, sometimes there are covenants in borrowing agreements with banks or bondholders that prevent ownership from changing hands without approval. In certain cases, even with approval there are financial penalties.

Aside from agreements that the purchaser of shares makes in which it is undertaken that shares will not be sold, there are issues related to the market for share sales. For one thing, there may not be sufficient market liquidity for the shares. This problem could arise in a country that does not have a developed capital market. Second, if the company is small and closely held a buyer may be hard to find. Third, the value of the company's shares may be declining and be lower than the cost of the debt incurred by the owner to purchase the shares in the first place. Fourth, the market might determine that the liquidation value of the assets is below the corporation's debt and assign no value to the shares at all. Fifth, the only interested buyers may fall into a restricted ownership category. For instance, there may be legislation preventing foreign ownership, or a single owner, from holding more than a fixed percentage of the company's total stock.

Consequently, the owner of shares may not be able to enjoy the right to sell shares ascribed to him or her by the property rights theory. The “legal” right may still be in place, but the “economic” right may not (Tittenbrun, 1996).

The right to transform the strategy/assets/resources. The property rights theory provides that, because the private sector owner has the right to alter a company’s strategic direction, reorganize its assets, and re-deploy its resources, the owner can create wealth. That wealth can be retained for the personal benefit of the owner. As mentioned above, in the simple case of an owner/operator or a closely held company, corporate control of the kind just described is feasible. But this may not be the case with complex organizations and multiple shareholders. For instance, a small shareholder in a widely held corporation does not set strategy. This is the purview of the board of directors. The small shareholder has relatively little impact on selecting the board, and not likely very much control over the direction it provides to management. Similarly, the board makes the determination to sell assets (unless they are not of a significant size, in which case management makes the decision). Sometimes even the board suffers restrictions on its ability to authorize asset sales. For example, agreements with lenders often require approval for material asset sales or changes to the nature of the business. The shareholder is clearly remote from these decisions. In the event that, the shareholder holds the shares through a non-voting trust, or has beneficial ownership in virtue of owning units in a mutual fund, the shareholder is further still from the locus of decision-making.

“Incentives” and “motivation” in the private sector. How are incentives such as having the right to receive a company’s dividends connected to motives? And what do motives have to do with the Property Rights School? Let us begin by recognizing that purposive human action, as opposed to random action, requires motivation. When selling stock, for example, the vendor must act intentionally and be motivated to do so. In turn, motivation can take the form of fundamental human drives (e.g., sex, hunger, thirst), emotions (e.g., love, hate, fear), wants (e.g., fame, fortune, beauty), and reasons (e.g., utility maximization). Reasons can vary widely with respect to specific content. And, qualitatively, they can be sound, ill-founded, irrelevant, and so forth. More importantly, reason is connected with each of the other categories of motivators insofar as the latter all need rational processes in order to be pursued. For instance, if greed motivates a business owner to sell her company at a premium price to a purchaser who intends to lay-off vast numbers of employees, the ability to reason is still required to make manifest that greed in the form of an executable business transaction.

PR connects a relatively limited basket of incentives, namely, the rights to corporate profits/dividends, sell shares, and transform the business, to reason in the form of maximizing utility. But, why is maximizing utility – i.e., self-interest – the only sound basis for business decision making? Utility maximization has competition as a reason for corporate action. People, frequently have other reasons for decision-making which are plausible and compatible with private sector corporate activity. For instance, many small businesses in the private sector are run less for profit than a love for the nature of the activity in which they are engaged. A specialty bookstore, for instance, may provide a low investment return for its owners, but be an outlet for their affection for books. Other

businesses are operated because they provide careers for owners and others. For example, the family owners and operators of an engineering firm may be better off financially by selling to a competitor. But, to the family it is rational to retain the company because it provides an opportunity for family and friends to work together. Further, if it becomes necessary, to restructure or layoff employees, the family knows it will be they and not others who make the decision. Reasons for decision-making such as friendship, loyalty, safety in the workplace, product quality, etc. do not form part of the PR presumption of self-interest. As well, company owners can have a sense of public responsibility. For instance, they might set policies that reflect a genuine concern for the environment or community service. Finally, enhancing shareholder value may drive decision-making at one stage in a company's history, and give way to other motivations such as product love at another. Perhaps the shift could be caused by diminishing marginal utility; or, maybe by a simple change of heart. Even "satisficing" – the motivation to advance somewhat one's self-interest without being inclined to maximize it – might account for a person's actions. In any case, human motivations can change over time.

Limitations on a Justification for Privatization

To give reasons why private sector business people may take decisions that are at odds with the PR rationale does not disqualify the theory's power to explain much legitimate corporate behavior. Nor does it in any way undermine the notion that a market-based economy is desirable. But it does chip away at the theory's capacity to justify privatization in any universal way – at least without some further theoretical support that accommodates other grounds for action, such as those mentioned above.

Public Choice Theory

The companion theory to PR is public choice (PC) whose originator was James Buchanan, the 1986 Nobel laureate. PR supports the case for privatization by demonstrating how private sector incentives generate economic efficiencies; PC explains how public sector incentives do precisely the opposite. Both theories have similar starting points. A market economy is presumed. And, each theory focuses on the individual decision-maker, and on his or her pursuit of rational self-interest. PC theorists maintain that politicians, bureaucrats, employees in public sector companies and interest group members are every bit as interested in their own wellbeing as their private sector counterparts. The fundamental difference is in the incentive structure. The bureaucrat is not driven by entitlement to dividends, stock price appreciation or strategic control of the business. He, or she, is motivated by salary level, power, and prestige. Salary is the principal driver. And, power stands in a causal relationship to salary. For bureaucrats (likewise for politicians), power is generated by the size of the bureau's budget, the ability to cause change, and the span of activities which fall under his or her control. In terms of a public sector business, volume of business and revenues rather than budgets are key. Prestige, or public reputation has some level of substitutability for pay, but it is its own end as well. Further, prestige also manifests itself in terms of perquisites such as office size, number of assistants, chauffeur, expense account, and so forth.

A manager who is primarily motivated by a high salary, which is driven in turn by increased output and revenue and growth, is likely to permit high operating expenditures. Profitability and value enhancement are not what is being rewarded and expenditures that depress profitability are not a deterrent for the bureaucrat or public sector company manager. Further, the public sector manager does not have to be concerned about how the equity markets might respond to poor financial performance. Shares are non-transferable, hence not priced by the market. Equally, there are no bankruptcy costs. It is unlikely that a government would allow its own businesses to fail. Even if it did, the economic consequences are spread over the citizenry, not just shareholders as in the private sector. So this is also not something that prevents excessive investment. Whereas in the private sector investment alternatives are calculated using a risk-weighted discount factor, the public sector calculation is often made using the government's borrowing rate – a much lower number. The result is that much higher levels of capital expenditure can be justified because the required return on investment is much lower. And, the reputation of the public sector manager is less affected by poor financial results as it is in the private sector. For one thing, not as much information about performance is available in the marketplace because of the absence of share prices, and, for another, there is a recognized general lack of focus on financial performance (Zeckhauser & Horn, 1989). Finally, as Tittenbrun (1996) points out, the public servant may have a much shorter expected time frame. A bureaucrat in charge of operating a government owned business could reasonably expect to be re-assigned after a few years. The long-term value of the entity is therefore of less concern than would be the case in the private sector.

One might ask whether there are not checks on excesses such as these. The answer, unfortunately, is that there are very few. The political masters of the bureaucrats are in much the same situation. A sitting government is not able to commit future governments since the latter can change priorities and even laws (Galal, Jones, Tandon & Vogelsang, 1994). They are office-holders for a relatively short period of time and so are inclined to see the short term as being more important. They do not have the profitability concerns any more than do the bureaucrats. Worse, they are subject to many political agendas that can lead to conflicting policy directives being given to the government owned entities (Yarrow & Vickers, 1989). As well, political objectives can get in the way of economic efficiencies. In cases where government-owned enterprises are in a monopoly position, information about the enterprise is under its own control – unlike private sector companies which have reporting requirements as part of debt agreements, stock exchange disclosure and reporting requirements, or shareholder information dissemination.

A limited check on bureaucratic excess could be the bond markets and rating agencies. As government enterprises accumulate debt from excess borrowing, and borrowing for entities whose risk rating is below that of government debt overall, the bond rating agencies will down-grade further government debt issues and the markets will take this into account in pricing future government debt issues. However, this check is very restricted in scope. It might work to some extent in cases where the debt of a particular SOE comprises as very high percentage of the state's overall debt. Political masters may fear the consequences of increasing debt burden in the form of public

disapproval or pressure from the IMF or World Bank and instruct the SOE managers to reduce the borrowing requirement. However, concerns about government bond prices and ratings will have little effect if the debt in question is being raised by SOEs off the government's balance sheet. And, even if the debt is held on the government's books, it is unlikely to have much impact on the decisions made by the managers of smaller government entities. After all, their individual business would not be responsible for affecting the state's overall situation.

Does the Public Choice Theory Justify Privatization?

As with the PR thesis, I think the PC view has an important fundamental point to make. People have reasons that motivate them to act, and rational self-interest is certainly one of them. But, is self-interest alone the driver of bureaucratic decision-making? It seems unlikely. Some bureaucrats simply love the political environment – its unpredictability and excitement. Equally, a public service career affords the opportunity to make a contribution to one's country, region, or community. For some, there might be an element of altruism in this. Others may pursue altruistic ends for self-interested reasons. It may give them pleasure to bring about public goods. Or, they may selfishly want to be seen to be the kind or person who is a promoter of public goods because it leads others to admire them. Whatever the case, the result is not necessarily the efficiency-hating result predicted by PC.

A second consideration is this. In PR theory, the private sector manager seeks personal gain by enhancing shareholder value. According to PC, the bureaucrat gains by achieving pay, power, and prestige. If we could show that a bureaucrat could be provided incentives to behave substantially like the private sector manager, the PC theory would collapse into the PR theory and be subject to virtually the same list of criticisms we made of it. Let us consider how this might be done.

To cause a structural change in the reward structure in corporations owned by government, or in enterprises that exist within government,⁴ two things would need to occur. To begin with, the management objectives and incentives should resemble those in the private sector. That is, commercial principles should apply to all investment decision-making. Capital expenditures, for instance, should be evaluated in terms of meeting prescribed investment return hurdles. Notwithstanding the desirability of undertaking a project based on service or output improvements, the return on investment criteria would have to be set at commercially viable levels. And these investment criteria should prevail over political expediency. Essential to this would be calculating the required returns by using risk-weighted cost of capital discount factors. Many governments assess project returns by using their own borrowing rates. (Worse, they sometimes assume that projects are financed by tax money that they mistakenly think has no cost!) Unfortunately, all projects have some level of risk associated with them. Using the government's borrowing rate – something which spreads the risks associated with all government financed undertakings – can ultimately damage the government's bond ratings because inadequate returns are received for projects thus financed. As well, using a discount rate that is too low encourages high levels of capital spending. So, the evaluation of a manager's

performance would need to contain some level of monitoring of capital expenditures. This could be done by requiring that an independent evaluation be conducted as part of an audit process, and management compensation to attached to its results.

Further, a “bottom line based” mode of compensation could be achieved by measuring financial results in much the same way as is done in the private sector. For example, in 1976, the Labour government in Britain established return on asset hurdles, along with borrowing restrictions from the government’s central treasury. The borrowing constraints were tightened by the Thatcher government and market-oriented management practices were instituted. The result was a considerable improvement in performance in steel, coal, rail, buses and postal services (Vickers & Yarrow, 1989). In general, performance targets could be the basis upon which the senior management of a public sector enterprise is evaluated. Monitoring could be performed by a board of directors which included a significant proportion of private sector members. The senior management could, in turn, structure performance-based incentives for subordinates along similar lines. Performance targets would, presumably be established for individuals in accordance with their areas of responsibility.

The second major structural change needed in public sector entities is restricting the accessibility of such enterprises to political fiat and non-commercial policy changes. For example, a government may have an incentive to operate a public enterprise in a geographical location that is inefficient from an economic perspective but which has political benefits such as creating jobs in an area of high unemployment (McFetridge, 1997). While there may be a beneficial trade-off, the public appearance of this is enough to curry favor with voters. Or, it may be politically expedient to ensure that an entity is overstaffed or has excess capacity to garner public satisfaction with service levels. This may make political sense, but it is uneconomic. So, the question is, can something structural be done to ameliorate this problem? The answer is similar to the point made above, namely, that an independent board of directors should be entrusted with oversight. Structural solutions to political meddling can be put in place. But political will to do so is crucial.⁵

What, then, is the status of PC as a justification for privatization? It has much the same standing as its counterpart PR. It argues for decision making on the basis of rational self-interest; but self-interest, or utility maximization, is simply different in form. What we have shown is that PC can be converted into PR given the right incentive structure. That being the case, the criticisms that we leveled against PR would be applicable to PC.

Can PR/PC ever Justify Privatization?

We have not completely rejected PR or PC because there are valuable points with them. But we have shown that neither alone, nor both in combination, will justify privatization, mainly because they are too narrow in their claims about human motivation. Could we try to amend the deficiencies and supplement the theories with the broader group of arguments we identified earlier? Perhaps, but I do not believe that even this would be enough.

The fundamental problem is in the very nature of privatization. It is an economic transformation: a change in condition, nature, or character of the economy. A well functioning market-based economy may be the desired end-state. But privatization is only the process undertaken to get there. As such, it must contend with the context in which the economic change takes place. The range of differing contexts in which privatization is proposed is so great that what might legitimate this process in one jurisdiction may not in another. So see why this is the case, let us consider what enabling factors are required for a privatization program. For without taking these considerations into account in making public policy decisions about privatization programs and how they will be executed, no complete justification will be possible.

Transformational Process and Enabling Conditions

Economy. First is the present condition of the economy. In order for a privatization program to be successful the economy must be capable of generating sufficient capital for the private sector to make the purchases of share or assets, or to enter into management contracts, joint ventures, etc. This implies an adequate level of national savings. Equally, to make those savings available for transactions, the banking system must be sufficiently well capitalized; and there must be adequate expertise within the banks to enable them to evaluate risk and lend against it. Further, beyond the banking system, there should be a viable capital market. In part, this is important in order to provide capital for the privatizations themselves. But, after the transactions have taken place initially, it is important for a secondary market to exist in order to provide liquidity for further trading hence additional capital for growth. Finally, the timing of a privatization program is important. If the economy is in a period of high inflation, newly privatized businesses risk not be able to obtain additional capital for operations or growth. And, its domestic market purchasers may be unable to support the new entities, especially if the inflation is spiraling.

Political. The second enabling factor is political. As a transformation process, privatization cannot successfully take place unless there is a political commitment to its success. The government must be prepared to withstand pressure from interest groups. And, there must be sufficient resolve to overcome resistance from the bureaucracy. We may have shown that a different incentive structure could motivate the bureaucracy to act other than to further their own interests, but the reality in many bureaucracies is that there will not be support for privatization. It is commonly believed that political will supporting privatization needs a senior level champion.

Public acceptance. Third, the political will must be supported by a high level of public acceptance of privatization. No matter what the theoretical commitment of elected representatives, if there is strong public resistance, there will be pressure to modify or even abandon the privatization program (or certain projects). In part, this means that the political mandate to privatize must be agreed upon by the public. Concerns about public welfare – workplace safety, employment, environment, and so forth – are frequently espoused by interest groups. Because of this it is important to communicate effectively

the objectives of a privatization program and ensure that people understand the impact that it can have. Fear of unwanted consequences can prevent privatization from ever being accepted.

Transactional factors. Fourth, are transactional factors. Privatization programs require expertise: evaluating the feasibility of specific privatizations, an understanding of financial markets, and the ability to manage privatization processes. This frequently does not exist within the government bureaucracy. So, it is essential that government has access to competent investment banking and financial consulting advice. In addition, it is sometimes necessary for new legislation to be created in order to execute transactions. (This was required when the Province of Ontario sold the Hwy 407 electronic toll road.) Further, labor relations and applicable collective agreements must be permissive. If union agreements are such that all employees must be guaranteed jobs in the new entity or given substantial severances, the privatization candidate may not be salable at an attractive price to government. Finally, there must be reliable financial information. Government entities are not always carried on government books as they would be in the private sector. Some costs (overheads) are not accounted. Equally, not all developing countries have adequate standards of financial reporting. In order to establish value and understand the revenue and cost structure, it must at least be possible to reconstruct financial records in accordance with some standard and internationally recognized set of accounting rules.

Regulatory regime. Finally, an adequate regulatory regime is crucial. Corporate laws are necessary to establish the rules of exchange, guidelines for securities issuance, banking regulations to determine the rights of borrowers and lenders, tax law which makes clear the manner of calculation and payment of taxes, legislation to protect intellectual property, and so forth. And, these laws must be enforceable in a court.

The items noted above do not constitute an exhaustive list. But in aggregate they clearly show how very complex can be the situational variables facing any government that is contemplating a privatization program. The PR and PC theories do not address these issues. For the most part these contextual details are assumed. In other words, the theories hold true, provided that the enabling conditions are assumed. Unfortunately, I think this is precisely why they cannot be adequate as a justification in a universal sense. This becomes clear when we distinguish two types of enabling conditions.

Standard versus Transformational Conditions

With respect to our review of enabling conditions, consider the difference between standard conditions and transformational conditions. First, standard conditions can be roughly described as those enabling conditions that are normally present, though they may be interrupted temporarily. As an economic example, we could say that the stock market is not receptive to IPOs of technology companies at present because listed technology stocks have been performing poorly in recent months. However, when the market improves, more IPOs of such stocks will be brought to the market. In this case, a receptive market is the normal state, however, the market is currently interrupted. Or,

because of interest rate spikes, the privatization of assets likely to require significant financial leverage is on hold. However, when rates improve, the privatization program will re-commence. Again, there is reasonable expectation that a fluctuating interest rate will return to a more stable structure in the future.

Second, transformational conditions are those in which the enabling conditions are not standard. They may have existed at one time but are not present, and not expected to be so, during the time frame relevant to the privatization policy. Such conditions would need to be brought into existence in order for them to play an enabling role in a privatization. For example, the IPO of a technology company is not possible because there is no domestic stock market. Or, the privatization of a national utility cannot take place because there is no domestic bond market, hence insufficient private sector capital would be available.

This distinction, with respect to the enabling conditions outlined above, is quite important to the credibility of a theory that aims to provide a universal legitimacy. Supporters of the PR/PC theory combination could argue that privatization is justified subject to the presence of specifiable standard conditions. The financial markets should be stable, there must be a political will, the public needs to be supportive of the policy, competent advisors must be available, and the regulatory regime must be in place. Any social science theory needs to accommodate some conditions of this sort. And a theory justifying privatization should too. After all, when looked at over time, the standard conditions set out the contextual environment for which the theory is being constructed. If we cannot accept them, we cannot have a theory at all.

But if the enabling conditions in question are of the transformational nature, could the justification hold up? Suppose there is no developed capital market, the banks have insufficient expertise or financial strength, the political policy makers do not understand privatization and do not support a market system, the public does not understand the working of a market economy, and the regulatory regime does not provide adequate corporate laws to govern such things as the protection of intellectual property or contractual relations. In this instance, a privatization would not be possible, so it would be ridiculous to say that it could be justified by PR/PC. Indeed, the theories would not even be relevant to a justification. The transformational conditions would need to evolve into standard conditions for the theories to be applicable.

Our final critique, then, of PR and PC is that neither, alone or together, will be able to function as a universal justification. Even if the theories were amended to deal with the criticisms leveled earlier, they would not, in principle, be adequate. The strength of the theories, and the reason why we selected them to critique, is that they had the capacity to show why, necessarily, a privatized entity would be superior to one in the public sector. The problem is, however, that a policy decision to privatize is crucially dependent upon contextual details – i.e., enabling conditions. While it might be reasonable to say that they theory applies, subject to standard conditions prevailing, it is not sufficient to hold out the theory as a justification when the conditions necessary are transitional in nature. As a result, PR/PC loses much of its force.

Any justification for privatization that does not take into account the enabling conditions in which the process is intended to take place will not be sufficient. This stems from the nature of privatization itself, namely that it is intended to apply precisely to those contextual matters. Because of the importance of context I want to close with an observation about the importance of education to privatization.

Privatization and Education

What we have said is that the justification of any privatization program is tied to situational specifics and that the five areas mentioned above are critical. Understanding plays a key role. It is incumbent upon the political policy makers to educate themselves adequately in order to make judicious policy decisions and to be able to communicate the relevant issues to the public in order to ensure well-informed public assessments of the policies. A review of our earlier discussions of the nature of privatization, its forms, means of execution, and enabling conditions suggests much that would fall within the realm of educational. But, in this concluding note, I want to focus on some of the considerations involved in a policy decision about privatization.

Recalling our discussion on economic and transactional enabling conditions, government at both the political and bureaucratic levels must learn about the financial marketplace. This does not mean that they need only to understand the economic principles that underlie a market economy. Rather, they must know, first, what the private sector will be looking for when privatization candidates are brought to market. What assets are most attractive given the business conditions of the day? For example, suppose a government is attempting to extricate itself from the ownership of a money losing pulp mill with antiquated processes and machinery. It is unlikely that buyers will be interested, unless of course the price of acquiring the mill plus the cost of updating the technology and facilities is less than the cost of building a mill or acquiring an alternate facility. Even then, there are considerations such as the current and forecast price of pulp, the availability of fiber source for the pulp, etc. The type of education required for specific examples like this is probably best acquired from investment banks and forest products consultants.

Second, policy makers must understand, better than most currently do, the elements that factor into the price that investors will likely pay. In other words, there must be an appreciation of how the marketplace values assets. Investors, typically, have a very different outlook than banks or bondholders. The investor will benefit from not only the cashflow or dividends generated by the business, but will have the advantage of capital appreciation. Investors, therefore, tend to focus on the future potential of the company, since that is one of the chief motivators of their decision to acquire. This we learned from our discussion of property rights theory. Banks and bondholders, on the other hand, normally receive only an interest rate. Their primary concern, therefore, is with the probability of getting their money back and receiving interest payments. They do not benefit from future value appreciation; they do, however, suffer if the value declines because of lower than forecast cashflow and they are not given their interest and loan payments. Lenders therefore give more careful attention to the historical cashflow

generation of a company than its pro-forma future prospects. In this they differ from investors. And, lenders are very attentive to the level or risk. They share this concern with investors.

Two things follow from this. To begin with, debt providers will only lend a portion of what they determine to be a conservative estimate of the value of the asset. This means that notwithstanding what the investor thinks is the value of the asset, there may be a restriction on the amount that can be paid for a privatization candidate because the lenders will not provide loans above the level at which they are comfortable. The further point is that if the lenders and the prospective investor both attach a high risk to the asset, this will be reflected in the lender's interest rates and the investor's required rate of return. The consequence is that a higher discount rate will be used by the purchaser to calculate value and therefore a lower price will be offered.

The educational implication is that if governments do not understand how the financial markets calculate value, they will not be well positioned to assess whether a transaction should be recommended. It is one thing to determine that a government-controlled enterprise no longer fulfills a public policy purpose and should be transferred to the private sector, and quite another to realize that the anticipated price will be so far below what was expected that the privatization candidate needs to be withdrawn. How a government can best educate itself depends upon its actual level of understanding and the educational resources available. Receiving presentation from investment bankers and others may suffice for learning about market conditions, but coming to understand the principles of valuation is likely best achieved through seminars and workshops which can be specifically organized by business schools or consulting firms.

Third, one of the enabling conditions we discussed was ensuring that the public support for privatization was obtained. To some extent this is a matter of communicating with the public: explaining why the privatization program is being undertaken and giving reasons for the selection of specific candidates. However, in many cases it is necessary to go beyond communication – to educate the public. Issuing discussion papers, news releases, and making announcements may not be enough. It may be necessary to hold focus groups, townhall meetings, and other venues in which public input is received and issues are openly discussed. What is necessary is to ensure that members of the public grasp the principles upon which decisions are being made; and understand how those principles apply to specific cases. One result of the process may be the amendment or even abandonment of some decisions. But the overall objective is to educate the public and to place them in a position to make informed judgements about the government's policy proposals.

Conclusion

The motivation for this paper has been the question of whether a universal justification for privatization is possible. We have sought to evaluate two of the most likely candidates for universality and found them to be highly problematic. We evaluated the property rights and public choice theories and determined that neither is adequate as a

justification because of the narrowness of their assumptions about human motivation. More significantly, though, it was argued that even if this problem could be remedied, the theories would be inadequate. Privatization is a process of transforming an economy. Such an undertaking necessarily involves the specific contextual details of the jurisdiction in which this is taking place. The PR and PC theories do not account for this, hence could not be counted upon to be universally applicable.

Endnotes

¹ Spulber (1997) points out that in Nazi Germany the main industrial companies were owned privately but were substantially controlled by the government. In this case, the existence of a private sector did not ensure the existence of a market economy.

² Of course, governments may be more driven by political than economic motives such as when government assets are sold to finance politically popular tax cuts or to avoid having to reduce spending on social programs (Clarke, 1993; Vickers & Yarrow, 1989).

³ For a good discussion of this theory see Tittenbrun (1997).

⁴ Zeckhauser and Horn (1989) maintain that an important distinction exists between a government bureaucracy that operates a business and a state owned corporation. This is at odds with the usual PC position.

⁵ For a good discussion of the importance and difficulties associated with separating economics and politics in an economy see Rowthorn & Chang (1993).

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