PRIVATISATION:

CONDITIONS FOR SUCCESS AND FISCAL POLICY IMPLICATIONS

by

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SECTION 1: INTRODUCTION

The policy of privatisation has come to be regarded as more of a creed than a principle of economic organization. As protagonists will agree, there is nothing new about seeking to reduce the level of State involvement in the economy. What is new is the passion and the fervour with which the State is being literally bundled out of domains which it has commanded for many a decade.

The fact that the economic theory that underlies the policy is not clearly spelt out, or that the empirical evidence in support of the policy is yet to be produced, seems not to matter at all. What is certainly true is that the doctrine has now been voluntarily adopted by many countries of the world, as well as by financial institutions that have influence over countries that may not have voluntarily opted for the policy.

In these circumstances it is important for economists and policy makers in the Caribbean to try to be clear on at least two questions. First, what are the conditions under which a policy of privatisation can yield positive net benefits to countries like ours? Second, since fiscal policy remains the dominant instrument of adjustment available to countries like ours, what are the implications of privatisation for the future design of Caribbean fiscal policy?

In this presentation I will attempt to sketch answers to these two questions, but more importantly I will seek to put on the table the range of issues which cannot be ignored, if we have to face up to the reality

of significant doses of privatisation as part and parcel of the conditionality attached to present and future multilateral financial support.

SECTION II: PRIVATISATION AND ECONOMIC PRINCIPLES

Before discussing the economic principles that appear relevant to a policy of privatisation, it will be useful to settle on what we mean by the concept of privatisation. It has become customary for the terms privatisation and liberalization to be used as both means of giving a greater opportunity for market forces to operate in the economy. For purposes of the present discussion I will want to use two definitions, a simple one, which is neutral to liberalization, and an extended one, which includes some form of liberalization.

Definition 1: (Van de Walle)

This simple definition sees privatisation as "a transfer of ownership and control from the public to the private sector, with particular reference to asset sales".

Definition 2: (Kay and Thompson)

This definition is consistent with the first definition, but is slightly broader in scope: "Privatisation is a term which is used to cover several distinct and possibly alternative means of changing the relationship between the government and the private sector. Among the most important of these are denationalization (the selling of publicly owned assets), deregulation (the introduction of competition into statutory monopolies and contracting out (the franchising to private firms of the production of State financed goods and services".

The point being made in both definitions is that although privatisation may be complemented by some forms of liberalization, there is no necessary identity between the two.

In order to identify economic principles and economic conditions for its success, it will be useful to state the economic objectives of privatisation. On this matter there is some divergence of opinion, partly due to the difficulty of drawing the line between the economic and political objectives of privatisation, and partly due to the fact that even in some of the more important applications of the policy, the full range of objectives has never been fully articulated.

For our purposes, however, we will assume that the dominant economic objective of privatisation is to deal with the problem of efficiency: allocative efficiency, productive efficiency and administrative efficiency. In the language of Public Finance, privatisation is aimed at eliminating excess burdens from the sphere of production. Some commentators have sought to include distributional objectives as being important, but we will not focus on this in this presentation.

If efficiency is the dominant objective of privatisation then the economic analyst is forced to go back to basics and ask the question: What is the relationship between ownership structure and economic efficiency?

There are two levels at which one can pose the efficiency question: the level of the firm and the level of the economy. At the level of the firm the matter can be put very simply. For if we assume the choice is between producing an output either under private ownership and producing it under public ownership, we will need to begin with some specification of the respective objective functions. In the case of the private owner, we can make the traditional assumption of profit maximization. For the public firm, the objective function may include other considerations.

Adopting an example used by Vickers and Yarrow, let us suppose that the other considerations like maintaining certain employment levels, and the enjoyment of certain perks are among these considerations. To complete the picture let us also assume that the activities of the private firm generate externalities. Using simple additive relationships, the two cases can be examined. In the case of the public firm, the index of social welfare would be calculated as the weighted difference between the index of public manager's welfare and that of the value of his perks. In the case of the private firm, social welfare would be calculated as the difference between the firm's profits and the value placed on the externalities.

If we can assume in this case that externalities tend to zero while perks do not, then profit and social welfare tend to equality and private ownership would be preferred. In this case profitability and efficiency will turn out to be two sides of the same coin. If on the other hand, perks are small relative to externalities, then the case for public ownership becomes strong. The former situation may be assumed to be one of perfect competition, while the latter can be compared to "a well-functioning political system". By this latter phrase we mean one where the monitoring system precludes rent-seeking and similar activities.

The first point that comes out is that efficiency depends on market structure in particular, and on initial conditions, in general. It is a well established principle that both allocative efficiency (optimising resource use) and productive efficiency (equating market with scarcity prices) would be assured under what Adam Smith called "universal competition". The brute fact is that the very survival of the firm will come to depend on its ability to manage its resources and to be able to work with prices that reflect scarcity values.

It is interesting to note at this point that Vickers and Yarrow identify three types of privatisation which

turn out to be relevant to the Kay and Thompson definition mentioned earlier. These can be listed as:

(a) *Selling to private sector individuals the assets of public sector firms operating in a relatively competitive environment;*

(b) *Selling to private sector individuals the assets of public sector firms operating in a monopolistic environment;*

(c) *contracting out of public services.*

From our previous discussion it would seem that type (a) privatisation is most likely to deliver the efficiency result because it is being applied within a favourable market structure.

The relevant question is whether public sector firms in the Caribbean operate within this type of environment. Partly because of the small size of the countries, such firms are likely to be in the minority. Moreover, where there is some element of competition it will certainly not amount to the "universal competition" which Smith referred to.

Where competition does not prevail prior to privatisation - as in the case of type (b) - the position is a little more complicated. For here policy makers will have to decide whether to liberalize the market structure prior to privatisation or as part of the process of privatisation. The history of the British experience in this regard is not encouraging. There seems to be little doubt that as the privatisation programme progressed the UK government became less and less willing or became unable to introduce pro-competitive arrangements either prior to, or during the privatisation process.

Again, considering the size of the Caribbean countries, it is unlikely that special efforts will be made

to actively foster competition among privatized firms. The reliance is more likely to create privatized monopolies which might then have to compete in the international market place. This is most likely to the case with the Region's airlines, for example.

However, this also raises the question of the government's regulatory or administrative capabilities. For if a regulatory agency cannot get the firms under its jurisdiction to set prices that reflect scarcity values, or to allocate their resources in a manner which keeps marginal productivities in line with resource costs, then the privatisation effort will not be able to lay claims to administrative efficiency.

The general point is one that recurs over and over in the literature. If economic efficiency is a genuine objective of privatisation then the focus of the privatisation cannot be on ownership of the assets but on the context with which the assets will be used. The tendency to point to high or rising profits of privatized firms may be good politics, but it does not begin to address the efficiency requirement. For, as Mansoor has argued, even if we can determine that one privatized firm is operating efficiently, we will still need to determine the impact of this firm on the others in the industry before we come to a final judgement. To the extent that one firm's "efficiency" is attained at the expense of others, nothing positive is done for the economy as a whole. The need therefore is for a general equilibrium approach to efficiency evaluation in the context of any privatisation effort.

In the case of small economies, this point cannot be over-emphasized. For in the final analysis the question really boils down to whether privatisation will induce the discipline of shadow pricing into production and investment decisions of privatized firms. In one sense this will be especially true of our use of foreign

exchange, and in our use of any public funds employed up in supporting privatized entities. The openness of the economies in the Caribbean would suggest that input and output prices cannot remain systematically out of line with international market prices.

However, as Berg and Shirley of the World Bank have indicated, too often privatisation carries with it the same kind of implicit subsidies which public ownership enjoyed. It is more than likely that where second-best optimization is applied to privatized entities in non-competitive conditions, international prices will turn out to be the limiting values for the shadow prices that reflect the special conditions of the economy in question.[1]

SECTION 3: FISCAL POLICY IMPLICATION OF PRIVATISATION

We turn now to the second question addressed in this presentation - the fiscal policy implications of privatisation. To begin with, it should be noted that there are both micro and macro fiscal policy implications of privatisation. At the micro level the chief concern is whether fiscal policy will support the drive for allocative and productive efficiency by eliminating hidden taxes and subsidies. At the macro level the concern is whether privatisation will distort the signals that guide the formulation or the implementation of fiscal policy by giving an erroneous impression about fiscal deficit. In both cases our argument will be that under a regime of privatisation, fiscal policy design and implementation will need to be much more fastidious than in the past.

Micro-economic Implications

In considering the micro-economic aspects of fiscal policy design, the primary focus has always been with efficiency. We seek to structure our tax regime in particular, to minimize the distortions that restrict production, investment and labour supply below optimal levels. In a context where resources are being relocated into the private sector, partly as a result of perceived government failure, it would be wrong to presume that market failures automatically disappear. What this means is that fiscal policy must now be even more circumspect than before in seeking to operate where possible with lump-sum type taxes or transfers.

Alternatively, where lump-sum taxes or transfers are not politically or administratively feasible, fiscal policy will have to face up to the requirements of an optimal taxation approach, where particular financing constraints are incorporated in the search for particular tax structures.

Fortunately much of the recent work in Public Finance has pointed to mechanisms for operationalizing optimal taxation approaches in real-world situations. The work of Stern and Ahmad on India and Pakistan, has applied this approach to tax reforms, but the basic message is that computable general equilibrium models simply have to become the vehicles of fiscal policy design activity. In these days of high speed mega-memory computers, with sophisticated packages, this requirement should not be beyond our capabilities. The days of a partial equilibrium approach to tax and expenditure policy design will have to come to an end once privatisation takes greater hold of our non-competitive economies.

As a bonus, what this would mean is that we stand a better chance of implementing the Charles Schultze approach to policy, whereby, in the face of market failure, we attempt to develop tax and subsidy measures which are market-like or incentive-oriented. Regulatory agencies, for example, will not be drawn into the information asymmetry trap when dealing with technical externalities.

What our discussion so far has revealed is the need for a higher quality of public sector input into decision-making if privatisation is to succeed in delivering results through the fiscal system. This point will recur as we move to consider the macro-economic implications of privatisation.

Macro-economic Implications

The major macro-economic implication of privatisation are concerned with the possible impact of privatisation on the budget balance. Mansoor, has argued that asset sales, per se, on a present value basis cannot be taken as either helpful or harmful to the fiscal position of the government. This is especially true

where we are not in a competitive world with full certainty.

In the short run, however, given existing accounting practices which incorporate asset sales as a financing item, it is technically possible to maintain higher-than-desirable levels of expenditure or lower-than-desirable revenue levels, because there is no immediate pressure to resort to borrowing.

During the period of asset sales therefore policy that is directed at bringing expenditure in line with the long run trend of revenues needs to be even more carefully developed and implemented. Where this means, improving financial controls or upgrading the audit function of different departments, the access to disposable funds should not be allowed to transmit the wrong signal.

The second point that needs to be made, concerns the use of the proceeds from asset sales. In times of financial stringency it will be normal for governments to want to use the proceeds of current asset sales to cover current expenditure. Since the superior alternative would be to invest the proceeds in enhancing the quality of the asset base remaining in the public sector, fiscal policy must ensure that the social rate of return from the use of the asset proceeds is at least as great as the interest rate - taken here as the opportunity cost of the funds. At the very least, this suggests that the proceeds from asset sales may have to be earmarked as additional funding for the Public Sector Investment Programmes (PSIP).

SECTION 4: PRIVATISATION AND STRUCTURAL ADJUSTMENT PROGRAMMES

It has been already acknowledged that privatisation policy is now a regular component of Structural Adjustment Programmes (SAPs). Apart from the basic efficiency objective which is assumed to be approached by reductions in the size of the public sector the SAPs seek to get the private sector investment process resuscitated. The underlying assumption here is that private investment is generally "crowded out" by public sector economic activity. The pressure for a general or across-the-board cut back in public sector economic activity therefore seems to fit both the privatisation and the SAP objectives.

Recent empirical work coming out of the International Monetary Fund has signalled caution in the pace and the manner in which public sector investment is being retrenched. In a 1984 study, Khan and Haque have found the public sector investment is an important factor in the growth of private sector investment in developing countries. More recent work by Villanueva and Greene has been even more definitive. The cases of crowding out are far fewer that those of "crowding in". What this suggests therefore is that to the extent that privatisation does not lead to an increase in public sector investment it will not lead to an overall improvement in macroeconomic efficiency.

The basic message therefore, is that privatisation will demand what Vito Tanzi calls a higher quality of fiscal policy design - one which counterbalances any tendency of privatisation to reduce public sector investment levels below those consistent with optimal growth. What is also suggested, however, is that an empirical knowledge of relative sector productivity measures is essential to the implementation a well-directed privatisation programme. This is brought out clearly if we use a the simple model which seeks to describe

the effects of privatisation on the overall level of production.

Privatisation and Overall Production - A Simple Model

Let us assume that the efficiency issue highlighted by privatisation comes down to determining the acceptable level of capital stock in the private sector in a context where this sector seeks to have its capital stock moving upwards to some derived target. Using a simple three-equation system we can extract interesting implications in respect of the policy of privatisation.

We begin with the assumption that the capital stock in the private sector, K_1, is determined partly by what the overall capital stock happens to be and by the amount of taxes that can be extracted from the private sector. Denoting the overall capital stock in the economy by K and the level of private sector taxation by T_2, and using linear specifications, we have as our first equation:

$$K_1 = s_1K + t_1T_2 \; ; 0 \leq s_1 \leq 1, \; t_1 > 0 \; \ldots\ldots\ldots \; (1)$$

We will assume for convenience that the taxation variable is predetermined by the balance of power or the relationship between the private sector and the government.

The economy's capital stock, K is assumed to be determined by exogenous forces, denoted by the variable Z. So we have as a second equation

$$K = kZ \; \ldots\ldots \; (2)$$

In the foreign-dominated enclave economies of the Caribbean Z may refer to the earnings obtained from the relevant enclave sectors. To close our system we assume simply that private sector capital is

defined as a residual. Our third equation therefore states that

$$K_2 \equiv K - K_1 \quad \text{........ (3)}$$

Substituting equations (1) and (2) into equation (3) yields the result

$$K_2 = kZ - s_1kZ - t_1T_2 \text{ .... (4)}$$

$$= k(s_2)Z - t_1T_2 \quad \text{........ (4a)}$$

where $s_2 = 1 - s_1$. The expression, (4a) states that the capital stock in the private sector would increase according to the coefficient, ks_2, as exogenous inflows increase, and would fall as private sector taxes are increased.

It is worth noting that in a context where exogenous inflows are increasing and where $ks_2 > t_1$ there is no private sector incentive to be concemed either about the tax regime or the size of the public sector's capital stock as denoted here by s_1. The possibility of both private and public sector capital growing side by side is very high once exogenous inflows are on the increase. The fact is there will be no crowding out and no taxation threat, especially if with increasing exogenous inflows, taxes are either reduced or the tax collection effort is allowed to weaken.

The situation changes drastically once exogenous inflows are either constant or declining. For immediately the taxation level, on the one hand, and the actual size of the public sector's capital stock, on the other, become a potent threat to the private sector's assumed desire to keep its own stock of capital on the increase.

If we therefore assume the economic context to be one where exogenous inflows are non-increasing

then the private sector appears to be faced with two non-exclusive options. The first is to instigate or negotiate a tax reform which effectively sets T_2 on a declining trend, or seek to increase its own share, s_2 of the overall capital stock. The expression (4a) therefore suggests that the tax reform and privatisation really have the common objective of increasing the level of capital available to the private sector.

Would the reduction in s_1, the public sector's share of the overall stock of capital, be beneficial to the economy as a whole? To answer this question let us first assume that production in each sector is carried out in accordance with a simple Classical one-factor production function. So we have

$$Y_1 = \alpha_1 K_1 \quad \ldots\ldots\ldots (5)$$

and

$$Y_2 = \alpha_2 K_2 \quad \ldots\ldots\ldots (6)$$

where α_1 and α_2 are the capital productivity coefficients of the public and private sectors, respectively.

By combining equations (5) and (6) with the rest of the system we know that privatisation will be successful in increasing overall output levels if

$$\delta Y_2/\delta s_1 > \delta Y_1/\delta s_1 \quad \ldots\ldots\ldots (7)$$

Not surprisingly, the condition (7) will be true if $\alpha_2 > \alpha_1$, that is, if capital productivity is higher in the private sector than it is in the public sector.

In this context it must be pointed out that studies which have sought to establish empirically the relative productivity levels in the public and private sectors have not come down unambiguously in favor of the private sector.[2] In referring to some of these studies, Oliver Letwin, one of Mrs Thatchers' technical

advisors does admit that the jury is still out on the sector productivity question.

There are two studies which, nevertheless, provide cause for some concern and certainly for caution where large scale privatisation is being envisaged.

The first study is that of Molyneux and Thompson whose results in 1987 confirmed those of an earlier study by Pryke some twenty years earlier. The major finding here was that, by and large, public sector productivity in the UK was not significantly different from private sector productivity.[3]

The second is Rati Ram's 1986 study reported in the American Economic Review. Here the author used data on 115 countries for the period 1960-1980 and came to the conclusion that factor productivity, when approximately measured, was generally higher in the public sector than in the private sector.

No doubt there will always be controversy about the empirical methods which different studies use when attempting to measure sector productivity. However, the message that seems to come across is that a basic condition for the high efficiency gains which appear to be the economic rationale for the privatisation, has not yet been sufficiently well established.

Given the apparent haste with which privatisation measures are being put together in a number of developing countries, as part of Structural Adjustment Programmes, the basic recommendation for Caribbean policy makers and for multilateral institutions therefore seems to be, festina lente - hasten slowly.

ENDNOTES AND REFERENCES

1. . *Reference to Danny Schlowdsky*

2. *For two relevant pieces of work see Anthony Boardman and Aidan Vining "Ownership and Performance in Competitive Environments: A Comparison of the Performance of Private, Mixed and State-Owned Enterprises", Journal of Law and Economics, April 1989, Vol 32, pp. 1-33, and John Vickers and George Yarrow, Privatization: An Economic Analysis, Cambridge:MIT (1988). See also George Yarrow, "Privatization and Economic Performance in Britain", Carnegie-Rochester Conference Series on Public Policy, August 1989, Vol 31, pp. 303-44.*

3. *Molyneux, Richard and David Thompson, "Nationalized Industry Performance: Still Third Rate?", Fiscal Studies, Feb., 1987, Vol 8, pp. 48-82.*