Public vs. private sector : an examination of neo-liberal ideology

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Public vs. Private Sector – An Examination of Neo-Liberal Ideology[1]

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Abstract

The paper reviews the theoretical underpinnings of the debate on the superiority of the public or private sector, and supports theoretical perspectives with help from empirical literature on the subject. The theoretical part covers issues relating to public choice, property rights and principal-agents relationship, while the empirical evidence includes review of literature on macroeconomic, microeconomic and welfare impacts of privatisation. The paper finds that despite numerous studies and unending discussions, the debate on the superiority of the public or private sector has remained inconclusive and is likely to remain so in the future. Notwithstanding the practical difficulties of making this assessment, the paper concludes that this debate is more ideological rather than empirical, since it is not possible to determine the superiority of one over the other through case studies, which can only be selective in nature.

1. INTRODUCTION

The last two decades have seen a wave of economic reforms designed to reduce the role of the public sector and expand the role of the market (Cook & Kirkpatrick, 1988). While the boundaries of the private sector are rather clearly delineated, those of the public sector are relatively obscure. In the public-private sector continuum, government departments and ministries lie on one side of the pole with the profit-oriented commercial private firms on the other. The remaining enterprises lie somewhere in between. Public enterprises, called both 'fish and fowl' by Laporte & Ahmed (1989), having a mix of commercial and social objectives, are represented somewhere in the middle of the continuum.

Who is superior – public or the private sector? This has been an unending debate. It has gained more importance after the wave of privatisations since early 1980s, in which the dominant motive was ideological rather than economic efficiency (Cook & Kirkpatrick, 1988). Privatisation, therefore, has its roots deeply embedded in the ideological foundations of the neo-right that perceives market as consistently and wholly benign

[1] The paper has also been hosted by Eldis at the following link: http://www.eldis.org/go/topics/resource-guides/poverty&id=23915&type=Document.

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(Martin, 1993), and finds the private sector inherently superior to the public sector. It believes in the “superiority of free market form of social organisation over the forms of social organisations of Keynesian welfare state” and sees free market as “an unambiguous advance on welfare state social democracy – as a provider of economic efficiency . . .” (Taylor, 1983: 6).

Two schools of thought represent the public vs. private debate. The public interest school believes that society has some common interests whom the state is competent to identify and serve. The private interest school, on the other hand, believes in man as a rational economic actor who will instinctively maximise his personal utility. This school accepts it as a morally valuable approach to life. Important underlying notions behind this debate are concepts of public choice, property rights and principal-agents relationships.

The rest of the paper is as follows. The next section discusses the theoretical underpinnings of public vs. private debate and examines the validity of arguments offered by the two schools of thought. Section 3 briefly reviews literature on the subject and tests arguments on the altar of empirical research, with section 4 concluding the discussion.

2. Public-Private Debate: Theoretical Perspectives

2.1 Public Choice

Public choice theory has strongly influenced public-private debate. The private interest school finds state restrictive and deterministic of public life, thus encouraging a dependency syndrome (Mackintosh, 1992). It assumes man as a ‘rational actor’ who has well-formed and logical preferences. He is a “rational utility maximiser” (Dunleavy, 1991: 31) who ensures maximum possible benefits and minimum costs. Using these presumptions, Downs (1967) describes a public official as an individual who would optimise his benefits, and his benefits are maximised in terms of pay, power and prestige when his organisation grows and he maximises his “budget” (Niskanen, 1973). Following the same logic, all public organisations compete for more “funding, staffing, policy ‘territory’ or other resources” (Downs, 1967: 53). Unless an official has to pay the cost of adding more personnel, he will be motivated to increase the size of his organisation indefinitely. Niskanen (1973) finds public officials as inherent maximisers yearning to be at the top of “virility index” - more resources they grab, better their performance on the index. He equates this behaviour as logical, and analogous to that of the owners and managers of private firms.

Adding to this is the dimension of exit and voice in which citizens acting as buyers/ consumers indicate their preferences by increasing or decreasing (entry or exit) their purchases (Van Mierlo, 1986). However, most of the government agencies work as monopolies giving public no right to choose. The non-excludable principle or the non-rivalry property, therefore, does not apply in this case with the result that the citizens can not 'exit' from the trap of state service monopoly, whatever the quantity and quality of provision. Likewise they can not 'voice' their dissatisfaction, and even if they do, they are ineffective and impotent. By privatising public provision agencies and introducing competition, they will have the option to reveal their individual preferences to achieve Pareto efficiency. To quote Atkinson (1989: 17)[3], "it requires no government legislation, consumers committees or thousands of letters to GEC or Marks and Spencer for an improvement in customer service. The consumer cracks the whip and the economically constrained come running." So there is a need to introduce market principles and competition in them and end their monopolistic nature.

An analysis of public choice theory shows that the rational economic man or *homo economicus* is not a universal truth. Brennan and Buchanan (1985)[4] put three arguments as to what is wrong with the idea behind *homo economicus.* Their first argument is that the model is generalised and presents only one motive, while the real motivation is far more complex and variable. Second, all one should assume from this theory is that individuals consider their interests, whatever they may be, to be different from those of others. They are not necessarily selfish or wealth maximisers. Christ, mother Teresa, kamikaze pilots and voluntary organisations are proof of that. His third defence is that since *homo economicus* seeks to maximise his economic well being, logically he should also advance his personal political interests. But we find that he does not always act like that. These arguments show that rational economic man or *homo economicus* does not sufficiently describe the human behaviour which is far more complex and intricate. This has been supported from the results of more than a thousand investigations by Lane (1991) who found that when basic standard of living has been achieved by members of a society, economic factors become far less important.

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[3] Quoted in Saunders, P., & Harris, C., 1994, *Privatisation and Popular Capitalism*, Buckingham: Open University Press.

[4] Cited in Stretton, H., & Orchard, L., 1994, Public Goods, Public Enterprises, Public Choice: Theoretical Foundations of the Contemporary Attack on Government, NY: St. Matrin's Press.

Public enterprises have also been criticised for their monopolistic nature. This means that they have no rival and can not be excluded. This presumption is also partially true. There are certain kinds of service provisions which are monopolistic in nature whether they remain in the public or private sector. In case of UK, the state had to live with monopoly in regional water companies due to the nature of service provided by them. However, in most of the cases, the principle of "contestable markets" ensures that even monopoly, whether in the public or private sector, would act as a potential threat as if working in a competitive environment, otherwise, competitors will enter the arena (Boettke, 1994).

2.2 Property Rights

Notion of property rights is one of the most important factors in public-private debate. This is evident from the fact that in countries where property rights do not exist or are ambiguously defined, privatisation has not progressed at a good pace (Van Brabanti, 1995). Property rights are important in explaining the use of resources in terms of both allocative and productive efficiency of firms (Vickers & Yarrow, 1988). Boycko *et al* (1997) view this as a system of control of rights and cash flow rights. Efficiency requires that these should be aligned. When major industries were nationalised in the post World War era, the idea was that profit motive had been removed and the public manager would act "in the public interest." Since this did not happen proves that man is not altruistic and unselfish but tries to maximise his own utility functions (Saunders & Harris, 1994),

One criterion for determining efficiency is ability to minimise cost. In public enterprises, working under the state umbrella, neither managers (agents) nor ministers (principals) have any direct interest in them (Wiseman, 1978), nor are they under pressures from the shareholders to run the organisation efficiently. Losses do not lead to bankruptcy since access to subsidised credit is available and public enterprises do not have to perform well to attract investment from private individuals or financial institutions (Saunders & Harris, 1994; Veljanovski, 1989; Vickers & Yarrow, 1988; Yarrow, 1989 and others). Under state ownership, pervasive political control and interference undermines efficient allocation of resources (Boycke *et al.*, 1997). Under private ownership, owners or shareholders have a direct stake in increasing efficiency. Managers face pressure from the owners or shareholders to organise business efficiently. Stronger property rights structures are related to higher levels of economic efficiency because of the incentives that induce this. Presence of property rights leads to competition. It is wrong to assume that this will threaten public welfare. Rather some welfare theorists have tried to prove that markets will eventually maximise social welfare (Kumar, 1995). Then under public ownership comes the question of rent-seeking behaviour when trade unions are able to obtain above market wages, employment levels and conditions of work at the expense of the consumer (Martin & Parker, 1997).

The discussion above assumes a stylised view of property rights and its relevance in the context of public-private debate. In multinationals, managers are as removed from ownership as in public enterprises. They do not have "ownership" stakes, but still run their organisations efficiently. Likewise, some pubic enterprises, like multinationals, are corporatised. They are listed in the stock exchange and the general public owns their shares. Apparently, there is little difference between the two. However, real weakness of the premise lies in the universality of world function capital market mechanism through which shareholders control and manage enterprises. This depends on the ability of the shareholders to mobilise themselves in groups, which may not be true in most of the cases. Capital markets of some countries may not be developed; shareholders may not be organised and thus ineffectual to put pressure on the managers of companies. Furthermore, this is also wrong to say that only stronger property rights lead to efficient allocation of resources. China is an excellent example, where even ambiguous property rights has not deterred a highly successful and efficient non-state sector (Li, 1996).

2.3 Principal-Agents Relationship

Principal-agents theory stipulates that one party (principal) delegates to the other party (agent) decisions over the use of property or property rights (Martin & Parker, 1997). The theory, discussing as to how the principal structures situations so that agents (being rational economic agents) do not shirk or subvert, tries to create assumptions about bureaucratic behaviour (Chan & Rosenbloom, 1994). This approach assumes a kind of special contractual relationship between the principal and agents instead of treating them as "mindless automata" (Dunleavy, 1991; Jackson, 1982: 2) or assuming a Weberian 'faceless' individual working in an hierarchical relationship. The model recognises the individuality of public officials. Though it is the principal who imposes structures on the agents, these are the agents who have effective authority. Enjoying a measure of autonomy, they are even able to modify the behaviour of the principal.

One of the most important problems in public enterprises is that of plurality of objectives. Unlike private enterprises who work only for profit, objectives for the public enterprises may be diverse ranging from commercial to social welfare, and efficiency and economy to equity. This becomes crucial since different actors (agents) may have different and even disparate and conflicting preferences (Jones, 1982). This problem does not arise in private enterprises. This has made Aharoni (1982) ask whether a public enterprise is "an agent without a principal". Howard (1982) tries to solve this problem by involving both state and "community", duplicating for the "market", as a principal. Adding to that is an almost ubiquitous problem of principal and agent colluding or colliding in order to maximise their interests. There are cases, when in the name of public interest, constant political interference (price cap, or changes in recruitment policies) is made in the affairs of enterprises to suit political expediency (Saunders & Harris, 1994). Privatisation, it is believed, would solve the problem. In the words of a former adviser: depoliticising the public sector was the "first and foremost" of the government's motive for the privatisation programme (cited in Saunders & Harris, 1994: 24).

However, many of the assumptions of principal-agents theory like pre-commitment for rewards or sanctions, and agents' purely selfish behaviour do not describe an accurate description of the relationship between the two and have little empirical support (Chan & Rosenbloom, 1994). Rees (1985) also agrees that a full generalisation is not possible, since the theory is based on the "assumptions of identical probability beliefs" (p.5). It creates a theoretical model of bureaucratic behaviour in an institutional vacuum. Regarding the issue of de-politicisation and de-bureaucratisation, it has not solved the problem. There are scores of examples in UK when privatisation was used to gain election campaign funds, and politicians and public servants got lucrative posts in privatised units. Schnytzer (1985) discusses the case of Czechoslovakia, Poland and Hungary where incumbent communists support privatisation because it provides them with an opportunity to transform political power into asset ownership.

3. Public-Private Debate: Empirical Evidence[5]

Privatisation is the most obvious reform effort and has become symbolic of public-private sector divide for the policy makers, academicians and the practitioners. There have been scores of studies analysing the performance of public and private enterprises from different perspectives. The following review examines literature with respect to macro-economic, micro-economic, and welfare impacts of privatization.

[5] This section draws from my PhD dissertation. Khan, Iram A. (2003). Impact of Privatization on *Employment and Output in Pakistan*. PhD Dissertation, University of Manchester, Manchester. Unpublished.

3.1 Macro-economic Impact of Privatization:

Most of the studies under macro-economic impact of privatization are theoretical, though some do portray practical scenarios. The thrust of all studies is that it is economic efficiency that leads to improved fiscal impact, though it is not clear whether privatization necessarily leads to reduction in fiscal deficit. This question is especially pertinent in case of developing countries where substantial investments in the public sector have crowded out private investment, and where the public sector has been a burden on the economy. State enterprises have been protected from competition, allowed both explicit and implicit subsidies, have enjoyed preferential access to funds from the public sector financial institutions, and given immunity from liquidation and insolvency. Ideally the fiscal impact of privatization is neutral; however, due to information asymmetries, market imperfections and the risk prone nature of the private sector, that may not be a practical scenario. The fiscal impact also largely depends on the way privatization proceeds are treated in the budget, the rate of return earned by the privatized enterprises and the rents the state is able to extract in the form of taxes.

A look at the empirical studies reviewed shows that different researchers have drawn different conclusions as to the efficacy of privatisation programme vis-à-vis its macro-economic impact. On the one side is a group of researchers (Barnett, 2000; Davis, Ossowski, Richardson, & Barnett, 2000; Plane, 1997a among others) who find that privatization not only leads to reduced net transfers but also rejuvenates the private sector as a whole, resulting in overall economic growth. Birdsall & Nellis (2002) conclude with reference to transitional economies that the economic growth was better in those countries, which were strong privatisers, compared with those where privatization was not adopted whole-heartedly. However, they also point out that this is not always true. Some transitional economies, which adopted a radical approach towards privatization and tried to divest quickly, are now in a mess whereas those that were cautious are now doing well. This shows that privatization in itself provided a short term relief, and inadequacies and structural weaknesses of the economies proved too overwhelming for sustained long term growth.

The other group (Chisari, Estache, & Romero, 1999; Galal, Jones, Tandon, & Vogelsang, 1994; Mohnot, 1993; Yarrow, 1993 and others) finds that privatization is a dynamic process and it is not possible to impute any positive or negative benefits directly to it. Rather it is the overall perception of political and economic environment that increases private investment, though the adoption of privatization policies does show a government's commitment towards promoting private enterprise. In the case of natural monopolies (e.g. utilities), privatization combined with regulation can result in significant macro-economic benefits. Pinheiro & Schneider (1994; 1995) find that ownership transfers are neutral from a fiscal perspective and privatization proceeds are often too little and arrive too late to help in times of economic crisis. Looney (1996) also finds in case of Pakistan that the fiscal impact will be neutral. Cook & Uchida (2001) and Ernst *et al.* (1999) discover a negative correlation between privatization and economic growth. We cannot, therefore, conclude definitively from the review of different studies that privatization always results in macro-economic improvement.

3.2 Micro-economic Impact of Privatization:

Though Kikeri and Nellis (2002) find sufficient and compelling evidence that privatization in competitive markets has a beneficial impact on enterprise performance in non-transitional economies, the studies reviewed cast doubt on the robustness of this conclusion. The pattern remains random and erratic whether these are country or cross-country studies. Different studies (Boubakri & Cosset, 1998; D'souza & Megginson, 1999; Ehrlich, Gallais-Hamonno, Liu, & Lutter, 1994; La Porta & Lopez-De-Silanes, 1999; Majumdar, 1998) find that the private sector is more efficient than the public sector and that privatization leads to a positive micro-economic impact. The World Bank has also reached similar conclusion that performance of the private sector is better than the public sector (World Bank, 1995). Cook (1997) questions the accuracy of methodology adopted in different studies on which the World Bank bases its conclusion, and finds contradictions in its approach. He also refers to the fact that the Bank has been selective in its approach and cites many studies that show that the public sector has an edge over the private sector. This is notwithstanding the scores of methodological problems that would make any such comparative analysis qualified and inconclusive (see Cook & Kirkpatrick, 1998 for discussion). Martin and Parker (1997: 217), after studying eleven British privatised companies, conclude that privatisation has not caused a significant improvement in performance. Whatever improvement there was, it pre-dated privatisation.

The literature review also finds instances (Ernst *et al.*, 1999; Grosh, 1991; Majumdar, 1998; Saygili & Taymaz, 2001; Weiss, 1995 to give a few examples), when the authors conclude that the private sector is not necessarily more efficient than the public sector, rather it is the public sector that is superior.

Most of the studies (Beyer, Dziobek, & Garrett, 1999; Boylaud & Nicoletti, 2000; Cam, 1999; Dewenter & Malatesta, 1997; D'souza, Megginson, & Nash, 2001; Eckel, Eckel, & Singal, 1997; Karatas, 1995; Martin & Parker, 1997; Omran, 2001; Plane, 1997b; Ramamurti, 1997; Sheshinski & Lopez-Calva, 1999; Wallsten, 1999, 2000; Yarrow, 1986), however, discover a mixed pattern and find that, though the adoption of privatization polices leads to improved micro-economic performance, the results cannot be directly imputed to privatization alone. There are factors other than ownership such as regulatory regimes, competition, geography, change in management, incentive structures, size and structure of the market, which also have a significant effect on a firm's performance. Ramamurti (1997), in his case study of Argentinean railways, discovers that the best option is to have a mix of both public and private sectors (also see Stiglitz (1992) for discussion). The private sector runs the railways, while the public sector provides subsidies to fulfil its capital investment requirements. Whatever the role of privatization in performance improvement, the argument offered by Dewenter and Malatesta (1997), Yarrow (1986) and the World Bank (1995) is convincing that privatization may not lead to efficiency gains but is necessary to "lock-in" gains and prevent backsliding.

3.3 Welfare Impact of Privatization:

Assessing the welfare consequences of privatization is complex due to multi-dimensional nature of the term welfare. Though many studies in the previous sections show that privatization, if implemented as part of an inclusive macro-economic restructuring programme, has had a positive impact on firms, very few studies (Galal *et al.*, 1994; Jones, Jammal, & Gokgur, 1998; Pollitt & Smith, 2001; Saunders, 1995) tend to confirm this. However, the study by Serra (2000) concludes that any positive welfare impact is due to the presence of competition rather than privatization.

Different studies (D'souza *et al.*, 2001; Haskel & Szymanski, 1996; Haskel & Szymanski, 1993; ILO, 1996) show that privatization, along with competition, regulation and commercialisation of a firm's objectives, has a negative association with employment and wages, though ILO (1996) concludes that this cannot be attributed to privatisation *per se*. D'souza *et al.* (2001) finds a similar negative correlation of employment with the level of foreign investment, size of the share issue in a capital market as well as higher state ownership (partial privatization). This largely negative welfare impact of privatization arises primarily due to government's attempts to induce efficiency in enterprises and maximise their sale proceeds by increasing tariffs before and after privatization. Since there is a trade off between profitability and equity, it is not surprising that privatization makes firms more profitable by reducing employment, wages and "rationalising" prices.

An important issue arising from privatization is retrenchment and voluntary retirement schemes. Almost all the studies (Assaad, 1999; Bhaskar, 1992; Bhaskar & Khan, 1995; Cam, 1999; De Luca, 1997; Plane, 1997b; Rama & Maclsaac, 1999; Tansel, 1998a, 1998b; White & Bhattia, 1998) find that privatization has led to retrenchment and layoffs. However, these authors disagree on the degree and scale of the loss. De Luca (1997) finds massive layoffs, while White & Bhattia (1998) conclude that there are job losses, though they are not correlated with privatization. Plane (1997b), on the other hand, finds that the experience is mixed and varies from company to company. Haltiwanger & Singh (1999) find no particular pattern emerging for preferring a particular retrenchment programme. Some studies (Bhaskar, 1992; Bhaskar & Khan, 1995; Cam, 1999; Ernst *et al.*, 1999) have highlighted another issue commonly associated with privatization: casualisation of jobs that worsens the welfare of employees, since they lose the social security benefits normally available to the permanent employees.

As for the impact of privatisation on stakeholders, some studies (Ernst, 1994; Harris, 1995; Nelson, Cooper, & Jackson, 1995; Shaoul, 1997, 1999) support the view that except for the private shareholders, all the stakeholders, especially the consumers and taxpayers, were losers, there are others (Bishop & Kay, 1988; Newbery, 2001; Newbery & Pollitt, 1997; Pollitt & Smith, 2001; Saunders, 1995) that point towards a positive relationship between privatization and stakeholders' welfare in terms of increased efficiency, improved levels of service and reduction in prices. Studies by Clarke *et al.* (2002), Estache *et al.* (2001), and Torero & Pasco-Font (2001) display that these benefits have been lost due to higher prices which have made some services inaccessible to the poor. As a whole we can say that the stakeholders benefit only when regulators act effectively and make sure that the private companies conform to the laid down standards in terms of quality of output and delivery. So it is not privatization alone but market, directed, steered and restrained by regulation that makes the winning combination.

4. Conclusion

The debate about the costs and benefits of private or public sector is infinite. It hinges on the economic and political merits of the role of government in society as well as the economics of ownership, and has found supporters on both sides of the policy divide.

Interestingly, privatization programmes were started in the 1980s purely "on faith" and not because the policy makers had found conclusive evidence for the superiority of the private sector. Megginson *et al.* (1994) point out that the academic literature then provided little guidance as to the costs and benefits of privatization or the best method of divesting public enterprises. Cook & Uchida (2001) find that privatization was initiated during the 1980s without much knowledge about its impact or contribution to economic growth. Suleiman & Waterbury (1990) and Ernst *et al.* (1999) also agree that the decision to privatise is ultimately a political decision. Though the sponsors of private ownership are in ascendance now, the state ownership was considered the most successful economic policy only a few decades ago. Plane (1997a) also comments that today's uncertain enthusiasm for the private sector is similar to the one policy makers once had for public sector-led development in the 1970s.

Furthermore, the provisos in studying the impact of privatization are subject to the economic, social and political factors prevalent in the country. The impact of these qualifications can be so enormous that Heller & Schiller (1989) are constrained to remark that the effects of initial conditions on the overall deficit can be misleading in evaluating the impact of asset sales. They also conclude that assessing the impact of privatization is based on assumptions, which are highly conjectural. However, the studies do show that only those mismanaged public enterprises could generate favourable budgetary impact, which were sold at competitive prices to buyers who could improve their performance and fully realise their market potential.

In most of the cases, increased tax revenue in the private sector could partially compensate for the loss of profits in the public sector, and the overall budgetary impact then depended sensitively on the sale receipts from privatization. Though privatization alone may not be the sole reason for improved efficiency, there is no denying the fact that competition and regulation would have remained elusive and of academic value in developing countries economies without the emergence of a potent and assertive private sector. The fact is that the private sector is superior in terms of efficiency and cost effectiveness only where the regulators have ensured a competitive market. Higher the degree of competition, greater the resilience and efficiency level of the private sector. However, we must not forget that due to the inherent trade off between equity and efficiency, the private sector, compared with the public sector, would opt for efficiency that can be translated into profit – its primary motive for survival.

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