Why do countries privatize?

Lecture 2

11 February 2025

Objectives of Course

- Understand the theoretical background for the privatization of state-owned enterprises (Why do countries choose to privatize State-Owned Enterprises?)
- Recognize the theoretical cases for State-Owned Enterprises (What are the main arguments for State-Owned Enterprises?
- Explain the theoretical cases against State-Owned Enterprises (What are the main arguments against State-Owned Enterprises?)
- Describe the fiscal and macroeconomic impact of privatization.

Why do countries privatize?

- In Chapter 1, we examine the forces that motivated governments to launch state-owned enterprises or to nationalize existing private businesses.

- Chapter 1 also described that most countries reversed the course from nationalization to privatization and launched mass privatization programs designed to reduce the state's role in running these enterprises.

Why Do Countries Privatize?

- Chapter 1 explored the reasons why governments establish state-owned enterprises or nationalize private businesses.

- It also explained how many countries later shifted towards privatization, implementing mass privatization programs to minimize state control over enterprises.

Why Do Countries Privatize?

- Raising money is a desirable objective, and most governments expect privatization to aid in developing national capital markets.
- The most crucial rationale for selling state-owned enterprises to private investors is dissatisfaction with their actual performance, along with the belief that privatization will significantly improve efficiency.
- There is an efficiency or productivity problem associated with state-owned enterprises.

Why Do Countries Privatize?

- Governments expect privatization to generate revenue and support the development of national capital markets.
- The key motivation for privatization is dissatisfaction with the performance of state-owned enterprises, along with the belief that private ownership will improve efficiency.
- State-owned enterprises often face efficiency and productivity challenges.

Why Do Countries Privatize?

1. Many governments and policymakers believe that privately owned companies are inherently better managed and more efficient than state-owned enterprises.
2. Firm managers, owners, and CEOs argue that private ownership enhances profitability and technical efficiency compared to state-run firms and competitive industries.
3. However, economists caution that private ownership can lead to inefficiencies in cases of market failures, inability to pursue socially desirable goals, and challenges in providing essential goods and services at fair prices for all citizens.

Why Do Countries Privatize?

1. Many governments and policymakers argue that privately owned companies are better managed and more efficient than state-owned enterprises.

2. Firm managers, owners, and CEOs propose that private ownership enhances profitability and technical efficiency compared to public enterprises.

3. However, economists caution that privatization can lead to inefficiencies due to market failures, inability to pursue socially desirable goals, and challenges in ensuring fair prices and access to essential goods and services.

Why Do Countries Privatize?

- The theoretical arguments for the advantages of private ownership of the means of production are based on a fundamental theorem of welfare economics: under strong assumptions, a competitive equilibrium is Pareto optimal, meaning that no other allocation of resources can make someone better off without making someone worse off.
- However, the assumptions underlying this competitive equilibrium include requirements that:
  1. There are no externalities in production or consumption.
  2. The product is not a public good.
  3. The market is not monopolistic in structure.
  4. Information costs are low.
- Thus, it is believed that market failure exists and that the government can resolve it.

Why Do Countries Privatize?

- Private ownership is often justified by welfare economics: If certain conditions hold, a competitive market is Pareto optimal, meaning that resources are used in the best possible way without making anyone worse off.

- However, this theory relies on key assumptions:
  1. No externalities
  2. The product is not a public good
  3. The market is not monopolistic
  4. Information costs are low (buyers and sellers have full market knowledge).

- In real world, these assumptions often do not hold, leading to market failures where governments may intervene to correct inefficiencies.

Recognize the Theoretical Cases for State-Owned Enterprises

- What are the main arguments for state-owned enterprises? There are three explanations:

  1. SOEs balance social and economic objectives rather than focus exclusively on profit maximization.
  2. It is a response to significant market failures, particularly the challenges posed to economic efficiency by natural monopolies, and a method to internalize production externalities such as pollution.
  3. It solves asymmetric information problems between the principal (the public) and the agent (the producer), where complete contracts cannot be written and enforced.

Recognize the Theoretical Cases for State-Owned Enterprises

- Governments establish state-owned enterprises (SOEs) for reasons beyond profit. Three key justifications are:

  1. **Balancing Social and Economic Goals:** SOEs focus on both economic efficiency and social welfare, rather than just maximizing profits.
  2. **Addressing Market Failures:** SOEs manage industries prone to natural monopolies (e.g., utilities, transportation) and help control negative externalities (pollution).
  3. **Solving Information Asymmetry Issues:** SOEs reduce information gaps between the public (principal) and producers (agent), especially when contracts are incomplete or difficult to enforce.

Recognize the Theoretical Cases for State-Owned Enterprises

A) State-Owned enterprises allows for the pursuit of social objectives, not just profit maximization.

1. It is the only effective way to ensure that commercial enterprises will pursue socially desirable but noneconomic objectives.
    1. Hiring members of underrepresented groups.
    2. Paying above-equilibrium wages.
    3. Constructing factories in underdeveloped regions of the country that would be unable to attract industry in arms-length terms.
    4. Produce more goods and services than would a private supplier and pricing these outputs at a lower than market clearing price.

Recognizing the Theoretical Cases for State-Owned Enterprises

A) State-Owned enterprises allows for the pursuit of social objectives, not just profit maximization.

- Unlike private firms, SOEs can prioritize socially desirable but noneconomic objectives.

- Examples of social goals pursued by SOEs include:
  1. Hiring members of underrepresented groups.
  2. Paying above-equilibrium wages to improve worker welfare.
  3. Constructing factories in underdeveloped regions to stimulate economic growth.
  4. Produce more goods and services than private suppliers and price them lower to improve accessibility.

Recognizing the Theoretical Cases for State-Owned Enterprises

B) State-Owned enterprises as a Response to Market Failures

1. Economists acknowledge that natural monopolies are a challenge for pure market economics. The only adequate response to natural monopoly is state ownership.

2. Private interests will inevitably restrict output to a level that maximizes profits at a socially excessive price.

3. If state-owned enterprises exist over natural monopolists, they can increase production and reduce output cost to optimal levels since the state is not constrained to maximize profits.

Recognizing the Theoretical Cases for State-Owned Enterprises

B) State-Owned Enterprises as a Response to Market Failures

- Some industries, such as utilities and transportation, tend to form natural monopolies, making competition inefficient.
- Private companies in these industries restrict output to maximize profits, leading to higher prices for consumers.
- If state-owned enterprises (SOEs) operate in these sectors, they can:
  - Increase production to meet public demand
  - Reduce costs to ensure affordability
  - Provide essential services without the primary aim of profit maximization.

Recognizing the Theoretical Cases for State-Owned Enterprises

C) State Ownership as a Response to Asymmetric Information and Incomplete Contracts

1. Managers have a better understanding of costs and production possibilities; they will inevitably have a negotiating advantage in setting output levels and pricing.

2. This asymmetry can render regulation of private enterprises ineffective, and the only solution in this case will be public ownership by a benevolent government.

Recognizing the Theoretical Cases for State-Owned Enterprises

C) State Ownership as a Response to Asymmetric Information and Incomplete Contracts

- Managers have a better understanding of costs and production possibilities, giving them a significant advantage in determining output levels and pricing.
- This information imbalance can make regulating private enterprises ineffective. In such cases, public ownership by a benevolent government may be the only viable solution to ensure fair pricing and efficiency.

What are the main arguments against state-owned enterprises?

There are three main reasons:

1. SOE managers will have weaker and more adverse incentives than managers of privately owned firms and thus will be less diligent in maximizing revenues and (significantly) minimizing costs.
2. State enterprises will be subject to less intense monitoring by owners because of collective action problems: Potential monitors have less incentive to observe managerial performance carefully and because there are few effective methods of effectively disciplining SOE managers if subpar performance is detected.
3. The politicians overseeing SOE operations cannot credibly commit to bankrupting poorly performing SOEs or even withholding additional subsidized funding, so state enterprises inevitably face soft budget constraints.
4. Politicians can use them to benefit their supporters at the expense of another group in society.

What Are the Main Arguments Against State-Owned Enterprises?

There are three main reasons:

- **Weak Incentives for Managers:** SOE managers have weaker incentives compared to private-sector managers, making them less diligent in maximizing revenues and minimizing costs.
- **Limited Oversight and Accountability:** SOEs face less intense monitoring due to collective action problems—stakeholders have little incentive to oversee management closely, and there are few effective ways to discipline poorly performing managers.
- **Soft Budget Constraints:** Politicians overseeing SOEs often continue subsidizing failing enterprises instead of allowing them to go bankrupt, making SOEs financially inefficient.
- Politicians can also use SOEs to benefit their supporters at the expense of other groups in society.

What Are the Main Arguments Against State-Owned Enterprises?

A) State-owned enterprises Are Inefficient Due to Weak or Adverse Incentives

1. Executive employees manage firms to maximize profit and owner wealth.
2. Increasing the firm's revenues and reducing costs accrue to the firm's owners provide a powerful incentive to maximize profit and invest in efficient operations and product innovation.
3. According to the study of Schleifer (1998), incentives to minimize costs, innovate new products, and improve quality are dynamic vitality of free enterprise.
4. The managers of SOEs have weaker incentives since they cannot personally reap the benefits of increasing revenues.

What Are the Main Arguments Against State-Owned Enterprises?

A) State-Owned Enterprises Are Inefficient Due to Weak or Adverse Incentives

1. **Profit Maximization in Private Firms:** Executives in private firms aim to maximize profits and increase owner wealth.
2. **Incentives to Cut Costs and Innovate:** Increasing revenues and reducing costs directly benefit firm owners, providing a strong motivation to invest in efficiency, operations, and product innovation.
3. **Findings from Schleifer (1998):** According to Schleifer (1998), incentives to minimize costs, develop new products, and improve quality are fundamental to free enterprise.
4. **Weaker Incentives in SOEs:** SOE managers have weaker incentives because they do not personally gain from increasing revenues, leading to lower motivation to cut costs and innovate.

What Are the Main Arguments Against State-Owned Enterprises?

B) State-owned enterprises Are Inefficient Due to Inadequate Monitoring and Asymmetric Information

1. Since governments or states in general own SOEs, no single observer has the appropriate incentives and tools to monitor SOEs management.

2. Since citizens cannot sell SOE shares and are rarely allowed to go bankrupt, the managers of SOEs have little reason to fear punishment for inefficiency (Vickers & Yarrow, 1988).

3. Asymmetric information also protects SOE managers from effective monitoring because they have superior information about firms' operations and costs, thereby negotiating this advantage as they deal with their political overseas.

What Are the Main Arguments Against State-Owned Enterprises?

B) State-owned enterprises Are Inefficient Due to Inadequate Monitoring and Asymmetric Information

- **No Single Authority for Oversight:** Since SOEs are owned by the government or state, no single entity has the right incentives or tools to effectively monitor SOE management.

- **Lack of Market Discipline (Vickers & Yarrow, 1988):** Citizens cannot sell SOE shares, and SOEs rarely face bankruptcy. As a result, SOE managers have little reason to fear punishment for inefficiency.

- **Information Advantage of SOE Managers:** SOE managers have superior knowledge of firms' operations and costs, allowing them to negotiate favorable terms when dealing with government oversight.

What Are the Main Arguments Against State-Owned Enterprises?

C) State-Owned Enterprises Are Inefficient Due to Soft Budget Constraints

1. If private firms' managers do not operate efficiently, they will be replaced by shareholders.
2. If a private firm cannot compete effectively with competitors, capital suppliers stop funding the firm's operations, and firms go bankrupt.
3. However, the managers of SOEs are rarely punished because of poor performance and are unlikely to go bankrupt in real life. They lack the pressure brought by capital markets and financial distress.
4. Since managers of less-prosperous state firms know they can rely on the government for funding, they face "soft" budget constraints.

What Are the Main Arguments Against State-Owned Enterprises?

C) State-Owned Enterprises Are Inefficient Due to Soft Budget Constraints

- **Private Firms Face Market Discipline:** If private firm managers do not operate efficiently, they are replaced by shareholders. If a firm cannot compete effectively, investors stop funding it, and it goes bankrupt.
- **SOEs Lack These Pressures:** Managers of SOEs are rarely punished for poor performance and are unlikely to go bankrupt. They do not face the same financial pressures as private firms.
- **Government Bailouts & Soft Budget Constraints:** Since struggling SOEs can rely on government funding, managers do not feel the need to cut costs or improve efficiency. This creates "soft" budget constraints, allowing inefficient firms to survive despite poor performance.

What Are the Main Arguments Against State-Owned Enterprises?

D) State-Owned Enterprises Are Inefficient Because Governments Use Them to Pursue Noneconomic Objectives

1. SOEs are inefficient because politicians force them to pursue political objectives (Schleifer & Vishny, 1994):
   - Maintain excess employment.
   - Build factories in politically desirable locations.
   - Price outputs at below-market clearing prices.

2. SOEs are beautiful vehicles for transferring wealth between groups precisely because their operations are nontransparent.

3. SOEs are subsidized to transfer benefits or wealth from unknowing groups in society to the politicians' supporters.

What Are the Main Arguments Against State-Owned Enterprises?

D) State-Owned Enterprises Are Inefficient Because Governments Use Them to Pursue Noneconomic Objectives

1. **Political Interference Reduces Efficiency (Schleifer & Vishny, 1994):** Politicians often use SOEs to achieve political goals rather than economic success, leading to inefficiencies:
    - Maintaining excess employment to gain voter support.
    - Building factories in politically desirable locations rather than the most efficient ones.
    - Pricing outputs below market-clearing levels, distorting the market.
2. **Lack of Transparency Enables Wealth Transfers:** SOEs operate with low transparency, making it easier for politicians to redistribute wealth between groups without public scrutiny.
3. **SOEs as Tools for Political Control:** Governments subsidize SOEs to benefit political supporters, often at the cost of taxpayers and economic efficiency.

The Fiscal and Macroeconomic Impact of Privatization

- Governments have strictly fiscal reasons for adopting privatization programs. Most obviously, governments can raise much revenue by selling their stakes in public firms through public share offerings or private asset sales.

- For many countries, an even more important reason to begin privatizing is to stop the outflow of public funds as subsidies for state enterprise losses.

Fiscal Impact and Macroeconomic Impact of Privatization

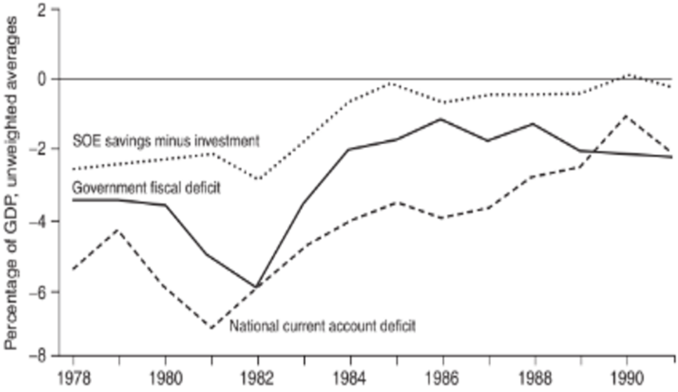

FIGURE 2.3. The fiscal impact of state-owned enterprise subsidies on national income accounts. This figure describes the fiscal drag that subsidizing SOE operating losses has on the national income accounts of 38 developing countries over the period 1978–1991. Source: World Bank, as reported in Figure 1 of Shirley (1999).

Fiscal Impact and Macroeconomic Impact of Privatization

- Figure 2.3 shows that SOE subsidies—proxied by savings minus investment—accounted for an average of approximately 2 percent of GDP for 38 developing countries from 1978 to 1983 and roughly 1 percent of GDP during the rest of the 1980s.
- SOE subsidies were much more burdensome than this for many individual countries.
- Subsidies accounted for an astonishing 12 percent of Mexico's GDP immediately before that country launched a sweeping privatization program in 1988.