PUNE RESEARCH WORLD ISSN 2455-359X
AN INTERNATIONAL JOURNAL OF INTERDISCIPLINARY STUDIES VOL 2, ISSUE 3

PRIVATIZATION-MICROECONOMIC EFFICIENCY AND FOSTER ECONOMIC GROWTH

AMRITANSH MISHRA
Assistant Professor
Department of Professional Communication
Invertis University
Bareilly. (UP) **INDIA**

ABSTRACT

Privatization increases profitability and efficiency in both competitive and monopolistic sectors. Full privatization has a greater impact than partial privatization and monopolistic sectors shows an increase in profitability that is higher than the component explained by increases in productivity, which reflects their market power. From the macroeconomic perspective, no conclusive evidence can be drawn, but the trends are favorable.
The microeconomic evidence extremely supports this implication.

Country specific data and cross-country data show that privatized firms improve their profitability after the sale, even controlling for macroeconomic and industry specific factors. This result is strengthen to different definitions of the profitability indicator, and holds different market structures. Deregulation policies have been shown to speed up the convergence process of firms to industry standards. Partial privatization has a lower effect on profitability when compared with full privatization.

Key words: *Microeconomic, Public ownership, Political perspective, Managerial Perspective, Infrastructure.*

BACKGROUND

Privatization has been a key component of structural reform programs in both developed and developing economies. The aim of such programs is to achieve higher microeconomic efficiency and foster economic growth, as well as reduce public Sector borrowing requirements through the reduction of unnecessary subsidies.

Microeconomic theory give us that incentive and contracting errors create inefficiencies due to public ownership, given that managers of state-owned enterprises pursue objectives that differ from those of private firms (political view) and face less monitoring (management view).Not only are the managers' objectives distorted, but the budget constraints they face are also softened. The soft-budget constraint arises from the fact that bankruptcy is not a credible threat to public managers, for it is in the central government's own interest to bail them out in case of financial distress.

INTRODUCTION

Privatization means the transfer of assets from the public (government) sector to the private sector. In the UK the process has led to a sizeable reduction in the size of the public sector of the economy.

State-owned enterprises now contribute less than 2 per cent of GDP and less than 1.5% of total employment. Privatization has become a common feature of microeconomic reforms throughout the world not least in the transition economies of Eastern Europe as they have made progress towards becoming fully-fledged market economies.

For several decades, both developed and developing countries have engaged in ambitious privatization programs. The number of privatization transactions has been growing over the years. As an illustration of the relevance of this policy,

Table 1 shows the change in state-owned enterprises' share in GDP between
1980 and 1997 for all the economies in the world, grouped by income level (according to World Bank classification) Even though the change does not only reflect to privatization strategies, it is strongly linked to it, as explained below.

It exhibits a major revision of the role of the public sector as owner of
productive assets in the economy.

Change in SOE's activity as a percentage of GDP
– Decrease in percentage points of GDP –

Countries (by Income Group)	**1980**	**1999**	**Change**
Low Income Countries	**15**	**2.5**	**-12.5**

Lower Middle Income Countries	**11**	**4**	**-7**
Upper Middle Income Countries	**-10.5**	**4**	**-6.5**
High Income Countries	**6**	**4**	**-2**

Source: Estimations based on the World Development Indicators, the World Bank.

The set of objectives privatization programs are meant to achieve is much broader and involve, as a fundamental component, the improvement of microeconomic efficiency. Indeed, in general there are four explicit objectives to those programs:

i) To achieve higher allocated and productive efficiency;
ii) To strengthen the role of the private sector in the economy;
iii) To improve the public sector's financial health; and
iv) To free resources for allocation in other important areas of government activity.(usually related to social policy).

The first two objectives have a normative rationale and relate to the microeconomic perspective. The latter ones, related to public sector finance.

This paper reviews the theoretical arguments behind the belief that privatization can achieve these objectives and provides a survey of the empirical literature which tests whether the effects have been observed in countries that have undertaken privatization policies. From a theoretical perspective,it is known that incentive and contracting problems create inefficiencies due to public ownership. This is so because managers of state-owned enterprises pursue objectives that differ from those of private firms (***political view***) and face less monitoring (***management view***).

The microeconomic empirical research of privatization has faced a severe data availability constraint. There are three groups of empirical studies: those based on firm-specific data in different countries with very small samples (*case studies*)

Studies with a large sample of firms in different sectors for a specific country (*within-country studies*) and cross-section analysis for privatized firms that are publicly traded (*cross-section studies*).

Those papers have shown important efficiency gains and productivity improvements in privatized firms – for well-defined measures – and allow us to evaluate the privatization experience from a microeconomic, partial equilibrium perspective.

The macroeconomic effects of privatization programs are more difficult to evaluate. Given the level of aggregation, it is difficult to isolate the effect of privatization on variables like GDP growth, employment level, and fiscal deficit.

The scope for the evaluation of privatization programs includes, as mentioned above, not only efficiency, but also equity issues. This paper argues that the distributive effect of privatization policies are definitely an area in which more research effort should focus, especially at the empirical level.

The paper has four more sections.

The second section is devoted to reviewing the theoretical arguments at the microeconomic and macroeconomic level that support the idea that private ownership is preferred to public ownership. Specific testable implications are proposed as guidelines to the empirical survey. Section three then shows a survey of the micro evidence and presents aggregate data to link the reform process with a healthier macro environment. One of the sectors in which most of the privatization activity is taking place, privatization of infrastructure, is discussed in part four. The last section concludes.

Theory

Privatization and microeconomic efficiency: The original debate

Microeconomic perspective:

Why ownership matters?

Privatization became one of the most significant microeconomic policies of the 1980s and 1990s.

This question can be re-stated by asking whether and in which ways the decision process of the firm is distorted when the government intervenes. This can be analyzed by looking at the components of the optimization problem: the objective, the constraints and how these are affected under different types of ownership structures.

At the microeconomic level, the empirical evidence strongly supports the view that privatization has positive effects on profitability and efficiency. It also shows that capital expenditures tend to increase after privatization.

One of the views in favor of privatization can be characterized by a moving away from the natural monopoly argument – appealing to the regulation literature and considering contracting and incentive problems within the firm as the relevant issues to foster efficiency at the microeconomic level. This perspective is termed the **agency view.** Within the agency view, there are two perspectives on the causes of the existence of poor incentives for efficiency. The first one, termed the managerial perspective, tells us that monitoring is poorer in publicly owned firms and therefore the incentives for efficiency are low-powered.

The second, the political perspective, claims that political interference is what distorts the objectives and the constraints faced by public managers Within the **managerial view**, the impossibility of complete contracts plays a fundamental role in explaining that why ownership indeed matters.

The political perspective:

The political perspective argues that distortions in both the objective function that managers seek to maximize and the constraints they face, through the so-called soft budget constraint problem, result in lower efficiency under public ownership. Public managers, who tend to report to a politician and pursue political careers themselves, incorporate to the objective function aspects related to maximization of employment – at the cost of efficiency – and political prestige.

The managerial perspective:

Imperfect monitoring is the first cause of low-powered incentives according to the managerial perspective. The reason why the managers of state-owned enterprises are poorly monitored has to do with the fact the firms are not traded in the market, as is the case of any private firm.

Debt markets cannot play the role of disciplining the managers, because SOE's debt is actually public debt that is perceived and traded under different conditions. Some have argued that partial privatization can solve this problem without having to pursue full disposition *(sale of an asset by a company).*

Summarizing the discussion from the microeconomic perspective, we can state the following testable implications:

Implication 1: Publicly owned enterprises in competitive environments do not perform better than privately owned companies in the same circumstances in terms of profitability and efficiency, and may perform worse.

Implication 2: Fully privatized firms should perform better than firms that have been partially privatized, under the same conditions.

Implication 3: Increases in profitability are not equivalent to increases in efficiency in general. This is only true in a competitive environment.

Cross-country evidence for developing countries shows that firms that were partially privatized realized lower profitability gains and productivity changes as compared to fully privatized enterprises from the macroeconomic perspective, the evidence is much far less strong and causality cannot be assumed. Important aggregate trends, however, have been identified.

Macroeconomic effects of privatization:

The discussion of the macroeconomic effects of privatization is not as rich from the theoretical perspective as that in microeconomics. There are few theoretical models that link the reform at the microeconomic level – such as privatization – with macroeconomic performance.

The first interaction between privatization and macroeconomics comes from the fact that macro instability, especially large budget deficits, tend to accelerate privatization. The effect of poor public sector financial health on the willingness to reform and on the political acceptability of such reform results in a clear relation between higher public deficits and faster public sector restructuring.

It is immediately obvious thus to look at the interaction between privatization and public sector financial health. Privatization allows the government to raise funds in the short term and eliminates the need of permanent subsidies to previously publicly owned enterprises.

Another important macroeconomic effect of privatization, especially when it is done through public offerings and mixed sales, is the increase in the level of stock market capitalization and, in general, the development of the financial sector. As shown, for example, in **World Bank (1995),** SOE's tend to crowd -out private investors in the credit market – given that they represent a less risky investment for the banks. Privatization mobilizes resources in the financial sector, reallocating credit to more productive uses.

Finally, from a theoretical perspective, the sale of public sector enterprises would reduce the aggregate level of employment in the short-run, because of the elimination of redundant labor. Unemployment, however, may decrease in the medium and long-run as the rate of growth of the economy increases as a result of the efficiency gains at the micro level and the increasing stability at the macro level.

Though the effect of privatization as such cannot be isolated, the implications that should guide the analysis of the aggregate data are the following:

Implication 4: Improves public sector's financial health (lower deficits, lower debt).

Implication 5: Has a positive impact on the development of the financial sector.

Implication 6: Has a negative effect on employment in the short-run, a positive effect in the medium and long-run.

Microeconomic evidence:

At the microeconomic level, the empirical evidence strongly supports the view that privatization has positive effects on profitability and efficiency. It also shows that capital expenditures tend to increase after privatization. The evidence on firm level employment is mixed – though for large firms employment seems to rise after disposition.

Macroeconomic evidence:

As mentioned above, there is no strong evidence regarding the effects of privatization at the macroeconomic level. It is possible, however, to give an overview of the trends observed in key aggregate variables and relate those to the privatization programs that have been implemented. Along with privatization, other structural reform measures were also put in place, to a certain extent, in most countries.

Privatization of infrastructure:

Though a detailed analysis of the privatization experience in infrastructure sectors would deserve a special study, we will show here some pieces of evidence that support the idea that in these sectors the benefits have also been important.

Infrastructure is crucial for generating growth, alleviating poverty, and increasing international competitiveness. For much of the 20th century and in most countries, the network utilities that delivered infrastructure services such as electricity, natural gas, telecommunications, railroads, and water supply—were vertically and horizontally integrated state monopolies.

But this approach often resulted in extremely weak services, especially in developing and transition economies and especially for poor people. Common problems included low productivity, high costs, bad quality, insufficient revenue, and shortfalls in investment. Over the past two decades many countries have implemented far-reaching institutional reforms—restructuring, privatizing, and establishing new approaches to regulation.

Conclusions:

From the theoretical discussion, several empirical implications have been proposed. Let us analyze how the evidence from different studies supports them.

Implication 1: Publicly owned enterprises in competitive environments would not perform better than privately owned companies in the same circumstances in terms of profitability, and may perform worse.

The microeconomic evidence overwhelmingly supports this implication. Country specific data and cross-country data show that privatized firms improve their profitability after the sale, even controlling for macroeconomic and industry specific factors. Partial privatization has a lower effect on profitability when compared with full privatization.

Implication 2: Fully privatized firms should perform better than firms that have been partially privatized, under the same conditions. Cross-country evidence for developing countries shows that firms that were partially privatized realized lower profitability gains and productivity changes as compared to fully privatized enterprises. From the macroeconomic perspective, the evidence is much far less strong and causality cannot be assumed. Important aggregate trends, however, have been identified.

Implication 3: Increases in profitability are not equivalent to increases in efficiency in general. This is only true in a competitive environment.

Two facts support this proposition in the data. First, it is observed in cross country studies that profitability increases more and productivity less in regulated or less competitive sectors. This shows that firms are exploiting, at least partially, their market power. Second, we observe in the case studies that consumer surplus is affected by the degree of competition in the sector, even though total welfare changes are positive.

Implication 5: Privatization improves the public sector's financial health (lower deficits, lower debt).

Implication 6: The budget deficit shows a positive trend, i.e., it declines during the reform period. Low-income countries, which are on average less aggressive privateers during the period analyzed, still have a significant deficit on average. Privatization has represented an important policy tool for fiscal reform.

Implication 7: Privatization has a positive impact on the development of the financial sector. Stock market capitalization has shown a steady increase in all country groups. In low-income countries this trend has been accelerated since the early 90s, when privatization transactions started at a faster pace.

Implication 8: Privatization has a negative effect on employment in the short run a positive effect in the medium and long-run. The effect on unemployment is ambiguous and no clear trend can be identified.

Finally, it is important to mention the lack of detailed research in the area of the effect of privatization on income distribution and poverty. Privatization of infrastructure services might indeed be a candidate for careful study to understand the role of market imperfections on efficiency and distributive outcomes. The latter is a promising avenue for future research.

REFERENCE

Vickers J. and G. Yarrow Privatization: An Economic Analysis. Vuylsteke, "Techniques of Privatization of State-Owned Enterprises"

Tutor2u.net/economics/revision-notes/-micro-privatisation-deregulation

Tutor2u AS/A2 Economics Blog

http://www.imf.org/external/pubs/nft/op/194/index.htm