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Privatisation and Public Sector Reform: The Political Economy of State Intervention

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The dominant ideas in development economics have changed considerably over the four decades of its existence. Similarly, the influence of theory on policy-making has also changed, not only with new ideas, but more importantly, with the ideological preferences of those with power and influence, especially at the international level.

During the eighties, development economics–which has emphasised market failures and other welfare reasons for judicious state intervention to ensure greater equity and efficiency–was under siege from the intellectual assault of market neo-conservatives in control of the major international economic institutions such as the World Bank and International Monetary Fund, and supported by the dominant ideologies of Thatcherism and Reaganomics at the global level. Political economy, rejected in the seventies as an unsophisticated nineteenth century approach appropriated by the political Left, re-emerged in the hands of the Right as the main weapon in this assault. The collapse of the Soviet Union and allied East European regimes and the marketisation of the remaining economies still claiming to be in the socialist camp only seemed to prove the worst claims of the generally politically conservative economic liberals of the late twentieth century.

By the early nineties, however, the pendulum seems poised for a return to the centre. Reagan was replaced by Bush, who was in turn defeated by Clinton with his ambiguous commitment to revive the US economy through selective state interventions. Thatcher was succeeded by Major, who is in danger of going the way of Bush for his handling of the economy. Reflecting its new found influence internationally, the Japanese Government funded a massive World Bank study of the so-called Asian miracle economies to emphasise the crucial role of the state in

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late industrialisation and rapid growth. Meanwhile, various regimes seem to be in trouble due to abuses of power and the role of the state in rent allocation and appropriation.

The State

Implicit in competing perspectives on state intervention, the public sector and economic liberalisation are different views of the state. An old divide has been between those who see the state as primarily the instrument of particular social interests and those who emphasise that the state is largely autonomous of such interests. These approaches have different implications for the presumed logic of state actions, with implications for the role, determinants, nature, scope, degree and beneficiaries of state intervention.

The now much criticised benevolent perspective of the state–implicit in much thinking in support of planning, state owned enterprise and other state intervention–is that the state is peopled by altruistic, competent and far-sighted individuals who would mobilise and deploy scarce economic resources as well as conceptualise and implement policies to achieve sustained growth and general welfare improvements. In the Third World, the private sector has often been depicted as weak, prone to speculation and profiteering and likely to sell out national interests for personal profit, while state intervention has been deemed necessary to protect the public interest, especially the poor, from private greed, and to undertake what short-termist, incapable, and poorly-capitalised private interests could not until an enlightened, nationalist and far-sighted entrepreneurial community emerged.

One crucial problem, of course, is the assumption of the continued existence of selfless, altruistic, devoted and enlightened public officials who resist opportunities to abuse the powers derived from their control over state intervention and the public sector. Another problem has been the inability to efficiently–and equitably–conceive of and implement strategies and modes of state intervention and public sector growth.

The malevolent ('predatory') view–recently popularised by public choice theory, the new political economy and some varieties of the new institutionalism–regards the state as essentially a collection ('mafia') of self-interested individuals primarily concerned with extracting rents in the form of economic resources. To legitimise such resource extraction ('plunder', 'looting'), the state is obliged to perpetuate certain myths about its *raison d'etre* and actions.

The autonomous-malevolent view then argues that the cumulative strength of powerful extensive state machineries will eventually result in the abuse of the public interest, with the state exploiting its powers to extract more resources from the disorganised public while rewarding organised interest groups–'distributive coalitions'–allied to the state's executive leadership. Property rights and entitlements are then designed to maximise the power and wealth of powerful individuals and interest groups, and to reward the faithful for their loyalty and support. The predatory view of the state and state intervention almost by definition implies short-termism in resource extraction, with its obvious implications for resource conservation and ecological balance.

What then is the relationship between state intervention and economic inefficiency? Directly unproductive profit-seeking (DUP) involves pursuing opportunities for profit without enhancing the productive forces of the economy. Most microeconomic analysis of this phenomenon has focussed on the role of the government in creating such opportunities through regulation of economic activity, though there is no analytical reason why such analysis of directly unproductive profit-seeking cannot be extended to 'distortions' due to unequal access to information, differential transaction costs or even poor operation and regulation of markets such as the stock exchange. The dominance of the (unproductive) financial sector in the less regulated Anglo-American economic systems, with its consequent domination over manufacturing, contrasts with the subordination of finance to industry in the judiciously more regulated Japanese and German economies. Similarly, there is little reason to presume that deregulation would ensure that investible funds would be more attracted to industry or agriculture, rather than finance, real property or construction, as has been the case.

However, the rentier nature or origins of income does not mean that such income will necessarily be subsequently deployed unproductively. Scale economies or other considerations may well determine that a perfectively competitive situation will be sub-optimal, in which case the question arises of how best to distribute or allocate such rents. Rather than insist on competition in such circumstances in a vain search for efficiency, which would effectively dissipate the rent through the expenditure of rent-seeking costs, the state could instead allocate such rents in such a manner so as to accelerate and direct the capital accumulation process, e.g. in favour of industrialisation. Hence, for instance, 'effective protection conditional on export promotion' policies have been used in Northeast Asia to push import-substituting industries to export through the use of conditional incentives. It is not the existence of rents in themselves which should always be the focus of concern, but rather their distribution or allocation and deployment for productive purposes.

In many circumstances, the existence or attraction of rent capture may well be the most effective incentive to encourage productive investment or economic activity, e.g. technology development.

Rent-seeking behaviour is therefore a subset of the broader analytical concept of directly unproductive profit-seeking, involving all types of rents and not merely those due to state intervention. Hence, state ownership of natural monopolies or natural resources may actually pre-empt, rather than encourage rent-seeking behaviour in such instances. Nevertheless, most recent analytical attention has focussed on rents attributed to state intervention with economic resources expended to gain privileges due to public policy, e.g. licences, permits, tariffs, discounted credit, etc. If such bidding is fully competitive, the gains from privilege should be totally off-set by bidding expenses, with no net gain to the economy. Interventionist states are therefore presumed to have a tendency to encourage rent-seeking. The best entrepreneurial and managerial talent, as well as the economic resources they are in a position to mobilise and deploy, may thus be diverted from directly productive activities in pursuit of rents. And after rent-seekers have secured their privileged claims to rents, they are likely to resist efforts to dismantle the regulations creating them.

State agencies tend to pursue their own typically expansionist interests, even at the expense of other state agencies, with state economic planners mediating among various lobbies. Since they tend to be mobile within the state machinery and move among different agencies, managers of public resources tend to favour current to future spending, 'front-loaded' over gradually staggered expenditure programmes, capital-intensive over labour-intensive projects, and short-term over long-term planning horisons.

In many post-colonial societies, there have not been classes or class fractions of sufficient economic and political strength and coherence to completely subordinate the state to their interests. Hence, the state has enjoyed considerable autonomy. The concentration of powers and discretion in the hands of the political executive–at the expense of the bureaucracy, the legislature, the judiciary and the constitutional monarchs–has enhanced the significance of this autonomy in operational terms, enabling the executive to make bold initiatives without seeking prior endorsement or support even within the state, let alone society at large.

However, state autonomy, in itself, is no guarantee of economic progress. The principal-agent relationship may be structured in such a manner as to effectively undermine, rather than enhance state owned enterprise performance. State owned enterprise board members are often politicians, political appointees or government officers with varying, though generally limited knowledge and understanding of the enterprise. While nominally representing the owner (the government), they have no personal stake in enterprise performance or profitability. Many may be inspired by a sort of bureaucratic imperative to demonstrate their powers by trying to show that they can exercise control. Enterprise managers may therefore see the government's representatives as interfering, or worse. Views expressed by the owner's representatives are often perceived by others as reflecting political decisions made elsewhere for reasons unconnected to the enterprise.

Property Regimes

There is little doubt that in many contexts, where the rule of law prevails, the legal designation of property matters. But the key question is not whether it matters, but rather how much it matters. There is little evidence that the change in legal status of former government departments and statutory bodies–as a consequence of corporatisation and privatisation–has in itself significantly improved enterprise performance. Key state enterprise managers are still appointed by the state executive even when the government's ownership share has declined to a small minority. Answering to shareholders, rather than to politicians, does not necessarily have a profound effect on management, perhaps because large enterprise managements are largely insulated from small shareholders without government influence.

It has been argued that if state owned enterprises are managed like private assets with hard budget constraints and the possibility of exit in competitive factor markets, there is then no economic advantage to retaining such assets under state control. *Ceterus paribus*, however, it should also be emphasised that there is also no disadvantage in doing so. In so far as state owned enterprises are generally also set up with redistributive goals, the key challenge is to ensure that this distributional commitment does not compromise enterprise efficiency. Although this distributional role is seldom separated from its economic role in practice, the fact that it can be distinguished in theory raises the possibility of doing this in practice. One major task of state owned enterprise reform then should be precisely this, i.e. developing operational strategies to ensure that state owned enterprises' distributional objectives do not subvert their economic efficiency.

It has also been argued that the fact of public ownership generates its own culture, which is said to be similar across otherwise different systems. The logic of the principal-agent relationship is said to over-ride the significance of culture, class and historical specificity. While this may be true of state owned enterprises, it is unclear why this should not also be true of large modern oligopolistic corporations, as Galbraith, Baran and Sweezy and others have observed. In other words, the principal-agent problem is not unique to state owned enterprises.

Why then is the legal form of the enterprise considered significantly more important as a determinant in this matter? The state owned enterprise form may well reflect the principal-agent problem, but surely, the legal form cannot be said to cause or define the problem. If greater accountability can be assured through state owned enterprise reform, it may well prove to be a superior solution to the principal-agent problem than the change of legal form as such, though admittedly, each legal form generally only allows a limited range of options. Admittedly, for example, the consequences of inefficiency, poor management and failure are very different for public and private enterprises, with only the latter facing the threat of exit. Before accepting the need for change in legal form, it first has to be shown why the legal form does not allow the substantive reforms recommended to enhance accountability and efficiency.

Property regimes and rights therefore count, at least in so far as they raise different expectations, and hence criteria for performance evaluation, and owners and managers consequently have to respond to different incentives. Property regimes define the institutional context for transactions, with economic agents having varying degrees of confidence that the rule of law, i.e. the rules and norms governing such transactions, will be observed. While it is presumably the state which enforces the rules embodied in the law, property regimes must also be sustained by widely accepted and hence self-enforcing norms, in order to minimise the transaction costs of monitoring and enforcing contracts.

However, it has also been argued that property regimes, in themselves, do not really matter. Large bureaucracies, both public and private, tend to encourage the blurring and duplication of tasks and responsibilities besides encouraging expenditure. In both situations, neither taxpayer nor small shareholder enjoy effective control, while managements can and do administer self-servingly and inefficiently. Individuals, reluctant to contribute to the costs of monitoring, hope to free-ride the collective benefits of monitoring by others, resulting in no monitoring at all.

It should also be emphasised that economic theory does not suggest that privately owned assets will perform better than state-owned assets in all circumstances. Rather, efficiency is ensured by competition in goods, capital and other markets. Some public assets may even be more efficiently run than private assets if the government enjoys information advantages about its state-owned enterprises which would not be ensured through mere regulation of private enterprise.

However, recognising information as a strategic resource, managers and bureaucrats may well withhold information to retain greater power, releasing it only to gain strategic advantages. They may also defraud the government in various ways. Hence, the theoretical information and regulatory advantages between the state and its agents may not be of practical significance.

The significance of the property regime in relation to the principal-agent problem seems to have been underscored by the apparent desire for privatisation without changes in management by state owned enterprise managers themselves, implying that the same managers can run their firms more efficiently under private ownership. But this desire could well arise from the perceived opportunities for rent capture through such privatisation by management buy-out (MBO). Also, this view implies that there are only two simple stark choices with ownership crucial, whereas there are, in reality, broad spectrums of choice involving different permutations of public and private ownership, control and regulation.

Not all state intervention in markets is, by definition, distorting, and not all distortion is necessarily undesirable in terms of either or both efficiency and equity. Theoretically, there is no reason for public property to be managed inefficiently either. Yet, however, the fact that most public assets are managed inefficiently and many interventions by the state cause unintended or undesired consequences has to be dealt with, even though these may be avoidable in theory. Public sector problems attributable to soft budget constraints, poor accountability, lack of competition and 'no exit' are believed to be common to most state owned enterprises, and desperately need to be addressed, especially by those not ideologically or dogmatically committed to abolishing all state intervention and state owned enterprises. The alternative is the recently popular conservative market economic agenda reflected in most economic liberalisation, structural adjustment and privatisation policy packages.

Inertia

It has also been argued that public sectors as a whole cannot be reformed without undermining their 'distributional logic' since the retention of assets under public ownership is a political, rather than an economic decision, although individual enterprises can be made more economically viable. This argument ignores the considerable welfare economic arguments for public ownership, e.g. of natural monopolies, by defining all distributional considerations as normative and hence political, rather than economic. It also assumes that the condition of the public sector at any point in time is the logical outcome or consequence of state policy or intervention, which in turn simply reflects the unchanging distributional goals or objectives of the policy intervention. Such a view derives from the comparative statics implicit in the underlying economic theory assumed, which has very little relationship to the complex dialectical dynamics as well as institutional inertia of political economy in history. Such a static perspective cannot even account for the constantly changing character of public sectors and the possibility of other changes, including those which would facilitate or even encourage greater overall efficiency.

Public sector reforms must involve changes at the enterprise level, i.e. the internalisation and implementation of broad policy changes, but the very commonalities shared by many state owned enterprises suggest that broad policy recommendations may be appropriate for the relevant enterprises. And if economic theory does not develop to accommodate such perspectives so crucial for relevant economic analysis, it will necessarily have to be transcended by and give way to meta-economic theory.

State owned enterprises have been set up for a variety of different reasons including market failures (e.g. for 'natural monopolies', or due to the long gestation periods required for certain types of investments), collective action problems (e.g. for scale economies in production and marketing, infrastructure provision, export promotion), promotion of particular sectoral or sub-sectoral activity, ethnic redistribution (e.g. of wealth, employment), and spatial redistribution (including regional or local development and agglomeration economies). While reforms for the public sector as a whole may be limited, there are nonetheless some reforms relevant for the entire sector, just as there are reforms only relevant for particular enterprises. there are also other reforms which, though not relevant for the public sector as a whole, may be relevant for enterprises sharing particular characteristics, which may be described as intermediate-level or meso-economic reforms.

Rational choice theory–which emphasises revenue maximisation, distributional coalitions and rent-seeking–predicts regime-generated change of an incremental, system-sustaining type, tending towards stability within existing arrangements, e.g. the reforms initiated by Rajiv Gandhi in India, and de la Madrid in Mexico and both Sadat and Mubarak in Egypt. However, rational choice theory seems to be a poorer predictor of the more recent, deeper and wider policy reforms initiated in both Salinas' Mexico and India under Rao and Manmohan Singh.

Organised interest groups seek and gain rents, eventually acquiring quasi-monopoly status through collusion, which tends to undermine efficiency and incentives. Even leaders who come to power with an economic mandate for liberalising reform have found it hard to give up the considerable powers inherited. For patronage and other purposes, ruling politicians quickly develop strong interests in retaining if not expanding the public sector. The array of interest which have benefited from the *status quo ante* may therefore seem so formidable and change therefore so unlikely until we consider the recent collapse of similar alliances in the Soviet Union and Eastern Europe.

Government officials and state owned enterprise managers themselves have an interest in maximising resource flows to the state-owned enterprises. More generally, bureaucrats–who determine the award of contracts and enjoy other discretionary powers liable to abuse in regulatory regimes–are in positions to materially benefit from the powers they enjoy. Together, such elements combine to create a certain expansionary inertia beyond the specific objectives and purposes of particular state-owned enterprises.

Other interests outside the state have also benefited from the growth of state power including much of the private sector, many of the intelligentsia and perhaps even a significant section of organised labour. Import-substituting industries enjoy tariffs, tax incentives, supply contracts and various other privileges, while export-oriented industries, especially resource-based industries, benefit from a different set of investment incentives including government credit support, production subsidies, etc. The substantial banking margins enjoyed by the financial sector, much of the most lucrative business and many of the business opportunities enjoyed by the domestic market-oriented private sector–including import substitution and non-tradeables–are ultimately determined by the state. Although state regulation certainly generates considerable resentment in the private sector, most of this is never public, thus reinforcing the public image of widespread acceptance, even approval. More importantly, rent-seeking costs may be well below the value of state support enjoyed and the actual rents captured, i.e. such costs of 'doing business' may well be considered worthwhile.

Change

Through revolutions, coups and elections, regime changes may occur, through which established beneficiaries can be displace by new interests, who may then use state resources very differently. Alternatively, existing policy may be problematic enough to precipitate economic and political crises, requiring policy reform to retain legitimacy and power. Also external powers, such as powerful and influential foreign regimes or multilateral economic agencies, may be able to exercise sufficient leverage over a regime in order to bring about radical policy reform.

While state institutions may not be mere instruments of class interests, autonomy does not guarantee that they are ahistorically 'rational' maximisers regardless of institutional context. Instead, institutional memory and social context may recommend options which are deemed more appropriate and acceptable.

Earlier statist strategies were generally not imposed from outside, though in many instances, they were inspired by diverse foreign ideas and experiences including Friedrich List, the Meiji Restoration, the Soviet experience, Keynesianism, Roosevelt's New Deal, European social democracy, 'structuralist' development economics and the early planning and import-substitution experiments, especially by intermediate regimes. Statist strategies were not simply the obvious logical outcome of dominant post-colonial class interests. Statist strategies have had a certain populist and inclusionist appeal, whereas economic liberalisation appeals to a narrower, arguably exclusionist, social spectrum.

Economic crisis changes the nature of interests resisting reform and allows for strategic breaks. While it is Machiavellian to suggest that economic crises have been exacerbated to create conditions more conducive to reform, it is generally agreed that server economic conditions generate an atmosphere more amenable to, and even desirous of radical policy change in the hope of quick recovery. Hence, the timing of controversial reforms (e.g. those favouring foreign investment) can ensure that they meet minimal resistance.

The voluntarist argument about economic liberalisation therefore claims that social and economic structures have retarded and may even obstruct change, but have certainly not determined the course of change, which has been set by heads of governments supported by insulated 'reform teams'.

Resistance

The task has been made easier because resistance to reform has been surprisingly weak since beneficiaries and advocates of policies to be abandoned cannot or will not put up effective coordinated or coherent resistance. As with other situations encouraging free-riders, rather than directly oppose change and bear the likely considerable costs of doing so, those adversely affected have generally tried to protect and preserve their own privileges while hoping for others to bear the costs of opposing change. It has also been suggested that 'resistance to change' changes with the change sequence itself. During the initial period of mild system-maintaining reform, beneficiaries tend to deny the threat of change, at least as long as they retain access to their privileges and do not feel that they have lost control of the reform process itself. But as the reform process deepens, the ruling coalition fragments unevenly at different moments for apparently different reasons, thus pre-empting the coalescing of coherent, consistent and coordinated resistance until it is too late. Resistance, if and when it does materialise, may not necessarily be due to rear guard actions or sabotage by statist conservatives or others adversely affected by the reforms, but may also be the consequence of contradictions of the economic liberalisation policies or the reform process itself.

Certainly then, vested interest have thus far been relatively ineffective in defending their entitlements and in resisting change because they view reform as a collective misfortune and hope that others will bear the costs of reform as well as ensuring collective survival while they individually negotiate new deals with the government leadership, as they or their predecessors had negotiated their entitlements in the first place. Since entitlements were originally granted and not won in most instance, they did not develop the organisational strength and resilience as well as experience of struggle and cooperation to better defend their own interests.

In so far as entitlements for the bureaucracy were largely granted by government leaders in need of a cadre to conceptualise and implement policy interventions and manage the expanding public sector, the limitations of bureaucratic resistance can be accounted for. In many cases, incumbent bureaucrats have not experienced dimunition of their formal positions, powers and entitlements, but only of their informal, albeit real status and incomes derived from the discretionary and other powers they enjoyed more of in a much more regulated environment with less executive hegemony. Hence, they are hardly in a position to publicly complain or explicitly organise resistance on such bases.

Comments on
"Privatisation and Public Sector Reform:
The Political Economy of State Intervention"

The paper by Jomo K. S. on "Privatisation and Public Sector Reform: The Political Economy of State Intervention" is a very topical and informative one as privatisation has become the central plank of economic reform packages whether for the developed countries or the developing ones. The paper also examines the issue of public sector reform, and indirectly, possibly, the role of the government in the economy.

Much literature exists on what the role of the government should or should not be in regulating or not regulating economic activity as state intervention can take many forms–for example laws to regulate monopoly power, the levying of tariffs, exchange restrictions, the issuance of permits, licenses etc. Such an activist interventionists policy requires a bureaucracy for its implementation discretionary power which can be used judiciously or non-judiciously. Such power can thus lead to corruption, inefficiency and a wastage of resources. Hence, it has become necessary to reduce the level of state intervention through the process of privatisation and deregulation as the current economic wisdom has it that the market can deliver efficiently what the state can not.

However it is important that certain conditions need to be fulfilled before a privatisation programme is to be carried out. These include the following to mention a few:

1. A strong commitment to privatisation by the government is necessary.
2. The privatisation process should be made non-political.
3. Privatisation should be implemented gradually with the sale of those industries that operate in competitive markets.
4. It is necessary to have the support of the major affected interest groups by giving them financial incentives.
5. Nationalised industries should be restructured before privatisation and competition should be maximised. Needless to say these conditions are quite difficult to fulfil.