

THREE LECTURES ON PRIVATIZATION

delivered at the

INSTITUTE OF ECONOMICS, JAGIELLONIAN UNIVERSITY, KRAKOW

and the

KRAKOW ACADEMY OF ECONOMICS

on April 3, 4 and 5, 1990

by

GEORGE YARROW

Hertford College, Oxford University

**Regulatory Policy Institute  
and Research Centre**

31-33 Westgate  
OXFORD  
OX1 1NZ

---



## THE ECONOMIC PERFORMANCE OF PUBLIC AND PRIVATE ENTERPRISES: WHAT ARE THE MAIN DIFFERENCES?

### 1. Introduction: organizational equilibrium

When seeking to compare the performance of different types of organization, it is conventional first to specify the relevant criteria to be used in ranking outcomes and second, using those criteria, to compare the performances of organizations operating in broadly similar circumstances.

The first step is complicated by the fact that there is no consensus about the relevant criteria to be used. In particular, views differ as to the appropriate objectives of public ownership. For some it may be an end in itself (private ownership of the means of production may be regarded as immoral), for others it may be a means of redistributing income and/or power.

In what follows, however, I will avoid this debate by simply assuming that the underlying objective is the achievement of economic efficiency. Public ownership can then be viewed as a possible response to market failure (i.e. situations where the market does not produce an efficient equilibrium) and, in general terms, whether or not private enterprises perform better than public enterprises depends upon whether or not the degree of market failure is exceeded by the degree of government failure.

The second step in the evaluation procedure is complicated by the fact that, to the extent that *natural selection* or *invisible hand* processes are at work (that is, to the extent that there is a tendency for inefficient patterns of behaviour to be replaced by more efficient alternatives), it is to be expected that each type of productive organisation would tend to be found where it was the superior option. On this basis private and public ownership would operate in similar circumstances only where performance was about equal. Empirical studies based upon such cases would, therefore, be biased towards the finding that no differences in performance exist.

Fortunately for the researcher (but not always for society) actual economies typically operate away (and sometimes a long way away) from such hypothetical equilibria. Standard empirical methods are not, therefore, undermined, although it should be noted that some bias toward "no difference" or "little difference" findings will likely continue to exist.

### 2. Theoretical analysis

Given the importance of the ownership issue in modern political history, it is remarkable that very little in the way of serious economic theorising about the relative merits of public and private enterprises exists in the literature. All too often analysis has given way to ideology.

Since there *do* exist well developed theories of private enterprise, the deficiency clearly arises from the lack of a general analysis of public enterprise. This may be the result of the substantial variations in political and institutional frameworks from one country to another, which are difficult to encompass in simple analytic frameworks.

Despite this weakness there are, I believe, certain propositions about relative performance that result from combining elementary theoretical reasoning with a minimal amount of factual material. For example, public enterprise has a general *potential* advantage arising from the fact that, in principle, the objectives given to managers can be chosen to correspond with social objectives. This advantage will, however, be insignificant where the more sectional goals of private managers (maximization of profit or shareholders' wealth) are aligned with public objectives by competitive market forces (see the classical invisible hand theories from Adam Smith onwards).

On the other hand, the relationship between managers and the ultimate "owners" of state-owned enterprises (the general public) is typically much more tenuous than that between managers and shareholders. In the former case the monitoring hierarchy is much longer, with both politicians and bureaucrats standing between the ultimate principals (the general public) and the agents (managers). Consequently it is to be expected that there will be a tendency for state-owned enterprise to be less

effective in attaining its nominal public policy goals than is private enterprise in achieving profit maximization. Put another way, public enterprise is more likely to be vulnerable to *goal displacement*.

An immediate implication of these two arguments is that private enterprise will yield the superior performance in market conditions where invisible hand theorems hold. And, in practice, given the magnitude of the monitoring weaknesses of public enterprise, these conditions can be generalised to those in which product market competition is reasonably strong (rather than perfect) and other forms of market failure (such as environmental externalities) are not substantial.

Where market failures are more severe the situation is much less clear cut. Here public ownership can be viewed as one of several possible means of responding to the inefficiency. For example, a tax on or subsidy to private enterprises might be judged a better way of responding to market inefficiencies associated with environmental pollution than is public ownership, whereas the reverse may be true if the market failure is due to natural monopoly conditions in an industry such as water or electricity supply. In general terms the choice here lies between *laissez faire*, regulation of private enterprises, and regulation *via* public ownership.

### 3. The scope of the state-owned enterprise sector in Britain

In 1979 the state-owned enterprise sector of the economy accounted for around 10.5% of gross domestic product, 8% of the labour force, 17% of the industrial capital stock and 15% of gross investment. The main industries and enterprises in the sector at that date are shown in Table 1, classified by the principal industry/enterprise characteristic or public policy goal that was responsible for their ownership by the state. A list of the major privatizations is provided in Table 2.

The greater part of assets is accounted for by the first column of Table 1. Thus, as in other western economies, public ownership was most closely associated with industries where two aspects of private sector performance tend to invite intervention:

- i) The tendency toward monopoly.
- ii) Wide spatial variations in prices due to economies of density.

In respect of industries in the first column, governments have generally sought to hold price levels down and to suppress spatial price differences (for equity or for simple political reasons). Since it is very difficult to allow any form of competition -- even the threat of new entry -- whilst suppressing price differentials, public ownership was typically accompanied by regulation to restrict competition.

Enterprises appearing in the other columns of Table 1 operated in product markets that either were or could easily be made reasonably competitive. This is particularly true of the fourth column, which contains enterprises that were being driven into bankruptcy by market forces before the state intervened.

### 4. Performance in the utility industries

Evidence from around the world on the relative performance (usually measured in terms of factors such as unit costs and factor productivities) of public and private enterprises in utility/network industries has failed to produce evidence that one or other form of ownership is decisively superior. Rather, what appears to matter most is the regulatory structure imposed by the state, which in turn depends partly upon government objectives.

A typical example of the type of empirical result to found in the literature in this area concerns the performance of the state-owned US Post Office following reorganization in 1971. Without any change in ownership, the regulatory changes produced a marked turn-around in performance, as illustrated by the figures in Table 3.

Evidence from British Telecom (BT) and British Gas tends to fit with the general, international pattern. From 1978 onwards, as a result of a drive to reduce the central government fiscal deficit, all state-owned enterprises came under pressure to improve their financial performance and productivity. In

effect the objectives of state-owned enterprises were changed so that priority was more and more given to commercial and financial goals. And the pace of change in this direction was particularly fast in the early 1980s.

To date, to the extent that there have been changes in the trend productivity performance of BT and British Gas these appear to have occurred in response to earlier developments in public policy toward state-owned enterprises, rather than to privatization itself (see Tables 4 and 5, where the year of privatization is marked by an asterisk).

Similar improvements in productivity are also to be found in network industries that have not yet been privatized. Thus, the recent performance of British Rail and the Post Office is shown in Table 6. These clearly indicate the acceleration in productivity growth that occurred as state-owned enterprises were increasingly required to give priority to commercial and financial objectives.

## 5. Performance in other sectors

In industries where product market competition is reasonably strong, international evidence tends to point to the superiority of the performance of private enterprises. While the post-privatization performance of British firms does not contradict this view it offers little in the way of further corroboration. There have been some major success stories, but the evidence overall is rather patchy.

Given that it is impossible here to do justice to the full diversity of cases, in what follows I will concentrate my remarks on just a few of the highlights.

### 5.1 Restructuring prior to privatization

Substantive enterprise restructuring prior to privatization occurred in three major cases: British Airways, British Steel, and British Coal (the last of which is still in the public sector but is scheduled for sale in the early 1990s).

British Steel and British Coal shared a number of common characteristics. Each had high productivity plants/mines, but a substantial proportion of both workforces was attached to low productivity production units (e.g. mines operating in poor geological conditions and outdated steel making plants). Trade unions were strong in both industries. Both enterprises were unprofitable. Both were partially protected from international competition by domestic or EC public policies. Neither was attractive to private investors.

In the event, both enterprises were restructured by the same individual, Ian MacGregor, who was first Chairman of British Steel and later of British Coal. And in both cases there were major strikes (the year long coal strike of 1984/5 was the bitterest industrial dispute witnessed in post-war Britain). The productivity and unit cost improvements have, however, been spectacular (see Table 7). British Steel, for example, moved from a unit-cost position near the bottom of the West European league table to being the lowest cost steel producer in the world in 1989.

British Airways was a rather different case in that it, although overmanned, its initial financial position was somewhat better than British Steel or British Coal. Thus, in principle it would have been possible to privatize the enterprise very much earlier, leaving more of the job of increasing productivity and cutting costs to the private sector. In practice, factors such as outstanding litigation in respect of North Atlantic routes delayed privatization, and British Airways provides another example of the capacity of managers to achieve rapid productivity increases in state-owned enterprises (see Table 8).

### 5.2 Financial performance

In competitive product markets it is reasonable to use movements in financial indicators such as returns on sales revenue or on capital as measures of changes in the efficiency performance of enterprises subsequent to privatization (and note that productivity changes are difficult to assess in multi-product firms that are constantly changing their product portfolios). Table 9 therefore provides such figures for a selection of relevant privatizations.

Some care does, however, need to be exercised in interpreting this type of financial information. The detailed application of accounting principles varies both among firms and over time. For example, an asset revaluation in a particular accounting year may reduce the measured rate of return on capital even though there has been no real change in the behaviour or performance of the firm. The data in Table 9 are, therefore, only likely to be useful in indicating very broad and clear trends.

Given this caveat, it can be noted that Cable and Wireless, Associated British Ports (ABP) and National Freight each show a record of steadily increasing profitability since privatization. In the ABP case the evidence for performance improvement is also backed up by productivity data which show output per head increasing at the very rapid rate of slightly over 11% per annum in the first four years after privatization.

The other cases are less clear cut. Britoil's profitability was largely a function of the oil price -- hence its collapse in 1986 -- and the company was taken over by British Petroleum in 1988. Jaguar cars produced average annual productivity growth of around 4% in the three years after privatization, but its precarious position as a small independent manufacturer in an industry (motor vehicles) dominated by major multinational companies was ended in 1989 when the company was taken over by Ford. British Aerospace operates in markets subject to cyclical fluctuations, long lead times in investment and lumpy orders. Given the nature of the marketplace, the company's recorded performance should probably be regarded as satisfactory.

### 5.3 National Freight

The privatization of National Freight, Britain's largest freight transport, storage and distribution firm, was distinguished by the fact that it was an employee buyout. Shares were initially traded only on an "internal" company market -- effectively only employees and former employees could own shares -- and the capital structure at the time of privatization had a very high ratio of debt to equity.

As in the cases of several other privatizations, there were substantial improvements in productivity in the period before flotation (the number of employees was reduced by approximately a third between 1979 and 1981). More than for most other cases, however, the performance improvement has been sustained in the subsequent period. Operating profits in 1988 were more than 4.5 times higher than in 1982, which, given the high initial debt-to-equity, has meant a rapid growth in the share price.

Indeed the equity capital base had increased so much by 1988 -- share prices increased by a factor of *thirty five* between the initial sale and the end of the 1988 accounting year -- that the internal market was judged insufficiently liquid for effective trading. As a result, the company became a quoted company in 1989, allowing shares to be traded freely on the London stock market, although certain privileges for employee shareholders have been preserved. The latter include a profit-sharing scheme and enhanced voting rights (two votes per share) on shares held by employees of the company.

The National Freight privatization illustrates the important principle that there are many different ways of developing increased incentives toward economic efficiency. Thus, although it can be argued that the restrictions on share ownership have weakened the capital market or external pressures for improved performance -- the company could not be taken over without the consent of its employee shareholders, for example -- the firm's capital structure meant that internal pressures for improved performance were very strong.

To illustrate, with a capital structure that is 90% debt a 10% increase in the market value of the enterprise translates into a 100% increase in share prices. As a result of this *gearing* effect, the employees who elected the management of the firm had a strong financial interest in increasing the valuation of the company.

### 5.4 Takeovers

One of the features of the post-privatization performance of several of the companies in Table 2 has been a propensity to engage in takeover activity of somewhat dubious merit for shareholders. In 1986, for example, British Telecom acquired a controlling interest in Mitel, a Canadian manufacturer of

private branch exchanges. In the event, the acquisition failed to achieve its objectives and British Telecom subsequently disposed of its interest at a considerable loss.

Other examples of major takeovers which were viewed by the market as expensive to shareholders include the Trustee Savings Bank acquisition of the merchant banking and investment Hill Samuel group (1987) and the acquisition of British Caledonian by British Airways (1988).

This raises the question of whether or not managements of newly privatized enterprises face sufficient pressures to act in the best interests of their shareholders. Particularly where the company is sold to large numbers of small shareholders, there is little prospect of owners exerting direct and strong influences on managerial behaviour. Moreover, managements of newly privatized companies in Britain often faced very little threat of an unwanted takeover themselves, either because they were protected by their sheer size or because, in several cases, the Government itself provided a period of temporary protection in the form of "golden shares".

While not decisive, the British evidence is consistent with the view that, in several important cases, the resulting weaknesses in capital market disciplines have led to inefficient takeover activity: *political discretion has partly been replaced by managerial discretion*. In this context it is worth noting that the substantial acquisition and disposal activities of the National Freight Corporation's management were significantly more successful than the average.

## 6. Conclusions

Despite the diversity of economic conditions associated with the various asset sales and the limited time spans since many of the flotations, it is nevertheless possible to draw some tentative conclusions from the recent British performance data. And, while the results of this exercise are generally unsurprising in the light of established economic theory and of international evidence, they are not always consistent with some of the more simplistic views concerning the impact of changes in property rights on performance. In particular, the hypothesis that privatization *per se* is always sufficient to create radically improved incentives for industrial efficiency is not well supported by the evidence.

It is certainly the case that for many firms there has been a history of improving profitability and labour productivity since privatization, but, over the relevant period, the same is also true of both the private and public sectors of the British economy more generally. At the end of the 1970s, international comparisons indicated that British industrial performance was lagging well behind major international competitors in a number of areas, and not least in privately-owned manufacturing industries. During the 1980s most sectors -- whether private or public -- have significantly improved their relative performance in respect of measures such as labour productivity. Indeed, the most spectacular improvement of all was achieved by the state-owned British Steel Corporation.

Given the available evidence, the strongest arguments in favour of the British privatization programme rely upon the more indirect consequences of ownership transfer. It can be argued, for example, that:

- i) the desire to privatize acted as a spur to improving the performance of state-owned enterprises in preparation for flotation, and
- ii) although it is possible for a determined government to provide strong efficiency incentives for public enterprises, this outcome is a matter of *discretionary* choice and is not compelled -- as it is after privatization -- by competitive pressures in the marketplace.

Both arguments have some merit, but neither is totally convincing. Thus, major changes in performance have occurred in state enterprises well before the prospect of privatization became a really serious consideration. And the mere fact of privatization does not guarantee that the enterprise concerned will subsequently be operating in competitive markets (governments can and do make discretionary decisions to protect an enterprise or industry).

My own view is that, in the end, the key issue concerns the public policy objectives that are being pursued. *Where the state actively pursues clear and simple objectives state-owned enterprises do tend to respond in an appropriate way.* Thus, in Britain, Ian MacGregor was given the *over-riding* aim of reducing the losses of first the steel industry and then later the coal industry -- a development associated with a marked shift away from earlier public policy objectives of protecting employment in the industries. The shift in priorities was then translated into a shift in behaviour. (It may be noted that even market economies choose to transform themselves into command economies when a single, simple public policy goal comes to dominate all others, as in times of war.)

The significance of public policy (or *regulation*) is also underlined by the economic performance of industries that are privately owned but where the state steps in to offer protection against competitive market forces. In Britain, as in much of the rest of Western Europe, the industry where costs of resource misallocations are probably greatest is not one that falls in the public sector. To the contrary, it is populated by very large numbers of private enterprises. It is agriculture.

A quick look at the operation of the Common Agricultural Policy is worth a tonne of economic theory in showing that private ownership *per se* is not the key to economic efficiency. Competition is crucially important, and competition itself depends in part upon regulatory policy in the widest sense (including, for example, a government's willingness to resist protectionist pressures). Thus, there may not be much to be gained from replacing state monopolies with private monopolies or state-sponsored private cartels.

Table 1. Nationalised industries and firms in 1979.

	MONOPOLY NETWORKS	NATIONAL SECURITY	INDUSTRIAL STRATEGY	DECLINE/FAILURE
ENERGY	Electricity Boards  British Gas	British Petroleum	British National Oil Corporation	British Coal
COMMUNICATIONS	Postal service  Telecoms	Cable and Wireless		
TRANSPORT	British Rail  National Bus  Airports		National Freight Corporation  British Airways	
WATER	Water Authorities			
OTHER		British Sugar	National Enterprise Board  British Aerospace  British Steel	British Leyland (vehicles)  British Shipbuilders  Rolls-Royce



Table 2. Principal asset sales, 1979-91.

Company	Year(s) of share issue
British Petroleum	1979, 1981, 1983, 1987
British Aerospace	1981, 1985
Cable and Wireless	1981, 1983, 1985
Amersham International	1982
National Freight Corporation	1982
Britoil	1982, 1985
Associated British Ports	1983, 1984
Enterprise Oil	1984
Jaguar	1984
British Telecom	1984
Trustee Savings Bank	1986
British Gas	1986
British Airways	1987
Royal Ordnance	1987
Rolls Royce	1987
British Airports Authority	1987
Rover Group	1988
British Steel	1988
The ten regional water companies	1989
Electricity distribution companies	1990 (1991 in Scotland)
Electricity generation companies	1991

Table 3. The US Post Office: Annual average growth rates of labour productivity and real unit costs, 1960-1983.

	1960-1970	1970-1983
Labour productivity	0.1%	3.3%
Real unit costs	1.2%	-1.0%

Source: Peltzman (1988), in MacAvoy, Stanbury, Yarrow and Zeckhauser (eds.), Privatization and State-Owned Enterprises (Kluwer Academic Publishers).

Table 4. BT: Percentage output and employment growth

Year <sup>1</sup>	Calls		Connections		Employment
	Inland	International	Business	Domestic	
1980	6	22	4.6	8.4	n.a.
1981	2	13	2.5	5.3	n.a.
1982	3	14	1.9	3.3	-0.4
1983	3	11	2.0	2.5	-2.4
1984	6	12	3.5	3.2	-2.4
1985 *	8	14	4.4	3.4	-3.1
1986	7	11	5.3	3.2	-2.5
1987	7	11	5.3	2.5	-2.2
1988	8	14	8.1	3.4	0.7

Source: Company Reports and Supplements.

Notes: <sup>1</sup> Figures in this and later tables are for the accounting period ending in the designated year.

\* Indicates the year of privatization in this and later tables.

Table 5. British Gas: output and labour productivity indices (1979 = 100).

Year	Output	Labour productivity
1979	100.0	100.0
1980	103.8	102.7
1981	101.3	98.6
1982	104.7	101.9
1983	101.5	101.9
1984	106.9	111.2
1985	109.9	118.7
1986	117.1	130.0
1987 *	118.6	136.5
1988	117.4	140.8
1989	113.3	141.0

Source: Company Reports and Accounts.

Table 6. Rail and postal services: annual percentage changes in labour productivity since 1979.

Year(s)	Rail	Post Office
1968-78 (average)	0.8	-1.3
1978-85 (average)	3.5	2.3
1986	2.8	3.7
1987	2.1	3.5
1988	8.3	2.8
1989	7.9	-

Source: Corporation Reports and Accounts.

Table 7. Steel and coal: annual percentage changes in labour productivity since 1979.

	Steel	Coal
1980	8.3	3.1
1981	-9.0	0.4
1982	54.3	3.5
1983	1.5	1.6
1984	31.0	-1.3
1985	1.4	-13.6
1986	11.1	30.7
1987	1.6	20.9
1988	24.0	10.0

Source: Corporation Reports and Accounts.

Table 8. British Airways: performance indicators

Year	Percentage growth in:	
	Available tonnes per km per employee	Passengers per employee
1982	2.5	10.4
1983	15.3	17.8
1984	9.7	9.3
1985	6.7	10.9
1986	3.9	1.3
1987 *	0.3	0.4
1988	5.4	9.1

Note: 1988 figures are not directly comparable because of the take-over of British Caledonian.

Table 9. Operating profits as a percentage of total sales revenue and net assets.

Year	British Aerospace		Cable & Wireless		National Freight	
	Sales	Assets	Sales	Assets	Sales	Assets
1979	7.5	15.4	28.5	27.3	-	-
1980	6.5	13.4	24.5	24.4	-	-
1981	5.7 *	10.5	21.8	19.2	-	-
1982	5.5	10.6	24.8 *	18.2	3.2 *	12.8
1983	4.9	8.9	37.4	23.8	4.6	18.8
1984	6.7	11.1	28.1	23.6	5.0	18.3
1985	8.0	12.5	28.4	23.2	6.2	19.5
1986	6.9	12.3	32.5	22.8	7.1	21.4
1987	5.3	11.1	37.4	23.8	7.1	22.4
1988	5.8	9.2	38.2	23.7	7.4	25.4

Year	Britoil		ABP		Jaguar	
	Sales	Assets	Sales	Assets	Sales	Assets
1979	41.6	-	21.7	17.2	-	-
1980	63.4	-	11.4	9.4	-26.6	-
1981	55.5	-	-3.7	-3.0	-15.8	-
1982	52.7 *	57.1	7.5	8.4	3.3	9.1
1983	49.9	51.9	9.5 *	9.6	10.8	46.6
1984	46.4	48.6	-4.8	-4.5	13.7 *	50.3
1985	42.0	46.4	13.0	11.9	14.4	46.1
1986	15.2	8.7	16.8	15.3	12.9	34.3
1987	35.5	-	19.6	19.5	8.4	25.6
1988	-	-	21.1	16.9	3.7	11.7

Year	British Airways	
	Sales	Assets
1979	-	-
1980	-	-
1981	-4.5	-8.5
1982	0.5	1.3
1983	7.4	19.4
1984	10.6	26.0
1985	9.9	30.3
1986	6.3	21.4
1987	5.3 *	18.4
1988	6.3	14.4

Source: Company Reports and Accounts.

## SOME LESSONS OF MRS. THATCHER'S PRIVATIZATION PROGRAMME

### 1. Introduction

When the Conservative Party came to power in 1979 its plans to privatize state-owned enterprises comprised only a very limited and modest set of proposals. No very extensive prior research had been done, and the idea of selling monopolistic enterprises in industries such as telecommunications, gas, electricity, rail transport and water supply had not been seriously contemplated.

In the event the Government's privatization programme was driven by a developing political momentum which carried it far beyond what were viewed as its initial boundaries. And, precisely because of its scale and scope, the British "experiment" offers a great deal of relevant information for other countries now examining the prospects for privatization on a yet larger scale.

This information does, however, have to be handled with some care. Just as Britain did not mechanistically adopt the US regulatory model when state-owned utilities were privatized, so it is to be expected that privatization in countries such as Poland, which are in a process of transition to market-based economies, will develop in new and different ways. In what follows, therefore, I have focused attention upon those lessons of the British experience that involve major issues of principle, rather than upon those institutional details that are more likely to be country-specific.

### 2. Objectives of privatization

The first point to be made is an obvious one: there are many ways to privatize an enterprise and many possible reasons for wanting to do so. *Put more technically, privatization is a policy process encompassing multiple objectives and multiple economic instruments.*

In Britain the three main objectives have been:

1. To increase economic efficiency at the level of individual enterprises and markets.
2. To raise revenue for central government.
3. To gain political advantage by means of transfers of wealth.

The weights attached to these potentially conflicting objectives have changed over time. Thus, the priority attached to the aim of increasing efficiency was rapidly surrendered in the early 1980s to the second, and later to the third, of the above objectives.

I would expect these three objectives to figure prominently in the formulation and conduct of public policy in Poland and its neighbours, although the relative weights that will be attached to each remain to be determined and may well differ considerably from country to country.

### 3. The policy options

Examples of the many different ways of privatization that have been used in Britain include:

1. Sale of shares in a joint stock company to the public.
2. Sale of a state-owned enterprise to a private company.
3. Management/worker buyout.

4. Contracting-out of services at the local government level via competitive tendering systems.

An important point to note is that, whatever the precise option that is adopted (and there are many more options than have been listed above), *there will usually exist other types of government policy that can be used to meet the specified objectives of privatization.* In some cases these alternative approaches may be substitutes for privatization, in other cases they may be complements.

To illustrate, consider the objective of increasing industrial efficiency. Efficiency will depend upon the incentive structures facing enterprises, and while incentives will almost certainly be affected by changes in ownership they will also depend upon a range of other factors, including competitive forces in product markets and the regulatory environment. The interactions among these various factors can be complex and one of the central lessons of the British experience is that *the effect on enterprise performance of ownership changes depends crucially upon other aspects of the firm's market environment.*

When evaluating policies, therefore, ownership transfer should not be considered in isolation. Unfortunately, in the early stages of the British programme *excessive preoccupation with the ownership question produced decisions that weakened the overall effectiveness of policy.* More generally, given that the problem is one in which multiple instruments are being used to achieve multiple objectives, policy coordination among departments, ministries and agencies to ensure that the overall mix is appropriate should be a high priority for governments.

Similar points apply in respect of the second and third of the listed objectives of privatization. Thus, finance for state activities can also be obtained by taxation or by borrowing, so the fact that sale of shares brings cash into the treasury should not automatically be classed a major benefit of privatization. And, as every student of politics knows, there are many, many ways in which the state apparatus can be used to redistribute income and wealth from one group to another.

4. Incentives and efficiency

Returning to the factors affecting incentive structures, available theory and evidence points to the conclusion that it is a combination of private ownership and product market competition that is likely to produce the strongest pressures on enterprises to improve their performance in meeting customers' demands. The following matrix summarises the ranking of alternatives that best fits the situation in Britain for industries in which competition is feasible:

	Competition	Monopoly
Private ownership	1	3/4
Public ownership	2	3/4

On this basis, the most powerful incentive effects will be achieved by moving from monopoly, whether public or private, to a competitive market with private ownership.

This transition is, unfortunately, not always straightforward. Indeed, as noted in the first lecture, most state-owned industrial assets in Britain were located in sectors where natural monopoly elements were a major factor. By definition, competition is difficult to achieve in these cases. Because of scale economies, for example, strong competition in naturally monopolistic activities tends to lead back to monopolisation. Moreover, monopoly positions in one activity can sometimes readily be extended to other, related activities.

In the network industries it is regulation (i.e. public policy) -- including *regulation to promote competition* as well as regulation of prices, quality of service, etc. -- that becomes the most important factor determining performance. Privatization will typically require regulatory reform, and *one of the effects of the privatization process in Britain has been to make the regulatory controls more explicit and less vulnerable to day-to-day political control.* These are advances, but the overall effect of the reforms is as yet unclear.

On the other hand, in some areas of economic activity the monopoly position of the state-owned enterprises had been due solely to state-erected barriers to entry. In these cases, therefore, the appropriate remedy was privatization accompanied by de-regulation or liberalisation of markets.

This last point should offer some encouragement to reformers in East and Central Europe in that, for a large proportion of economic activity, the initial position is indeed one of public enterprise protected by state-erected entry barriers. *Privatization accompanied by de-regulation/liberalisation to increase product market competition (via, for example, less protectionist trade policies) therefore offers the prospect of major efficiency gains*, although the transition may be painful (because of malfunctioning markets elsewhere in the economy, such as the markets for labour and housing).

The transitional costs will not, of course, be spread evenly throughout the population, and another lesson from the British experience is that *there may exist powerful interest groups who are particularly opposed to increasing competition (whilst possibly welcoming privatization)*. In Britain, these included not only the management and the workers of many of the enterprises concerned -- for whom a quiet life and a share of monopoly profits can appear preferable to the rigors of competition -- but also various financial advisers to the government, for whom it was easier to sell a steady stream of monopoly profits than an income stream that was uncertain as a result of competitive threats.

In contrast to these well organised and influential pressure groups, the groups who would benefit most from competition (consumers and potential entrants) often have a weaker voice in the policy process. Political pressures can, therefore, work against policies aimed at promoting competition.

## 5. Public finance

Except in economies where other fiscal instruments are severely lacking, I believe that the single biggest pitfall to avoid in privatization programmes is giving too high a weight to the objective of raising revenue for central government. This is because, in practice, it has tended to imply an upgrading of an objective (raising finance) that (frequently) can easily be achieved by other means at the expense of objectives (e.g. improving incentives by increasing competition) that tend to be much more difficult to reach with alternative instruments. Or, in other words, it tends to be associated with an inefficient overall policy mix.

In Britain, the public finance objective has tended to be pursued at the expense of the goal of improving incentives by promoting product market competition. There were two basic problems here:

1. Higher revenues could be achieved from the sale of monopolies than from enterprises operating in more competitive environments.
2. In my view more importantly, given that most state-owned enterprises were in industries where promotion of competition was not a straightforward exercise (e.g. network utility industries), a more strenuous attempt to develop competition would likely have delayed privatization (as has happened in the electricity supply industry case). Since the revenue-raising objective derived chiefly from short-term macro-economic expediency, competition was sacrificed to increase the speed of flotation.

Here, however, is an example of a weakness of British policy that cannot mechanistically be translated into a "lesson" for policy in countries that are in transition from central planning to market-based systems. The principle is the same -- raising finance for the state budget is generally better achieved by other means -- but the precise implications for policy are very different.

In Poland, for example, if a high weight is attached to the finance objective *the effect is likely to be an unnecessary slowing down in the pace of privatization* (rather than, as in Britain, a speeding up of the pace). The slowing down effect will occur because a fast rate of flotation in a thin capital market will imply low treasury receipts. The delay is unnecessary because (again unlike Britain) a large proportion

of Polish state-owned enterprises falls in sectors where product market competition can be simply and rapidly increased (e.g. by a liberal trade policy). For these enterprises delay simply means a longer wait for improved performance, and in practice it may also lead to the development of greater political pressures *against* policies to increase product market competition.

#### 6. Political advantage and social justice

Around 1982/3, at a relatively early stage of its privatization programme, the British Government discovered that, in the flotation of state-owned enterprises, under-pricing of shares is a politically attractive way of redistributing wealth.

To illustrate, consider an enterprise whose flotation could potentially raise \$8 billion. If the shares are sold at a 25% discount the treasury will forego \$2 billion of revenue which, for current purposes, we can assume will be made good by higher taxes than would otherwise be imposed. With an adult population of, say, 40 million this implies tax bills that are higher to the extent of \$50 per adult, a sum that is likely to go unnoticed in that it is a small fraction of the average tax burden.

Suppose next that the shares are sold to 2 million individuals, who collectively will enjoy a capital gain of \$2 billion (the market price of shares will settle at 33% above the issue price). The average gain is \$1000, a much more significant sum and one which is likely to be linked clearly in the investor's mind with privatization. Investors will therefore tend to be grateful to the government that gave them such a bargain and, in a democratic political system, the incremental votes could easily be decisive in settling the outcome of subsequent general elections.

Estimates of the magnitude of under-pricing of shares in Britain are given in Table 1 for some of the major flotations and there has, rightly in my view, been much criticism of this process on the grounds that it offends against social justice. Despite the Government's rhetoric (to the effect that the aim was simply to "widen share ownership"), if the people as a whole are regarded as the beneficial owners of state enterprises then citizens who for one reason or another do not take up shares in the privatized enterprises are being partially expropriated (to the extent of the \$50 per head loss in the hypothetical example given above). Moreover, since the latter tend to be the poorer and less well informed sections of the community, the redistribution of wealth is *regressive* in the standard sense of that word.

The economic justice point can be met if shares in state-owned companies are distributed equally, at zero price, among the people. With Eastern European policy issues in mind, it is useful to consider why this course was not followed in Britain. There are, I think, two main reasons:

1. The political effect would have been weaker. The average gain would have been smaller and much less targeted on individuals likely to be "swing" or "marginal" voters.
2. Whereas underpricing implied foregoing a fraction of government revenue from the flotation, free distribution would have meant the foregoing of all revenue from the flotation. Thus, just as the revenue-raising objective came into conflict with policies to promote competition and efficiency so it also came into conflict with policies that would have promoted equity.

I am no expert in the politics of Poland or its neighbours, but I suspect that there are fewer potential payoffs to using privatization as a means of achieving a regressive redistribution of wealth. At least I hope that is the case, for, if it is, *there are great opportunities for going beyond anything thus achieved in the West in terms of creating a market economy in which property rights in industrial assets are widely distributed throughout the population.* Arguably at least, *such wide share ownership will serve to underpin political support for the difficult transition to a market economy.* What chiefly stands in the way is the revenue-raising objective.

If the revenue-raising objective is downgraded it will be possible directly to exchange the implicit, non-tradeable property rights of each citizen for explicit, tradeable rights. The key aspect of a market

economy is precisely this ability to trade, and the point I am making is that the goal can be achieved without any superfluous, accompanying redistributions of wealth. Thus, redistributions of wealth from poor to rich or from domestic nationals to foreigners (when the latter acquire under-priced shares) are not inherent features of privatization: they can be avoided if policy makers so choose.

#### 7. Transactions costs

When privatization of enterprises occurs by means of an offer of sale of shares to the capital market, an often neglected aspect of the process is the magnitude of the transactions costs that are involved. These expenses cover a wide range of activities, from preparation of prospectuses and advertising, through merchant banking and advisory services, to underwriting and commission fees.

Table 2 shows estimates of the transactions costs associated with some of the earlier privatizations in Britain. It can be seen that in the flotations of British Telecom and British Gas the ratios of expenses to proceeds amounted to 6.8% and 6.4% respectively, and the combined expenses amounted to over \$1 billion. Moreover, these figures exclude costs borne by the companies themselves (merchant bank and advisers fees, managerial time, and marketing and promotion services) as well as indirect costs borne by the state (e.g. the time of civil servants). To say the least, this was not a cheap way of privatizing just two (albeit large) enterprises.

In addition to these items, there is a real cost to any nation when foreigners are able to purchase shares at prices that are below true market values. In the British Telecom flotation, for example, and depending upon how the calculations are done, it has been estimated that this factor was responsible for a loss of up to \$300 million to British taxpayers.

I have been a critic of the size of these transactions costs, and I hope that this will be another mistake that your Government will avoid. Standing back from the situation a little, it is hard that to believe that there can be any enthusiasm for paying large sums of money to (mainly foreign) advisers, banks, etc. either to sell to the Polish people assets that they already (beneficially) own or to sell Polish assets at discounted prices to foreign investors.

#### 8. Effects of privatization on enterprise employees

At one stage in the early 1980s privatization was seen as a potential instrument for reducing the power of trade unions. The underlying point was that trade union bargaining strength was increased by the absence of bankruptcy threats in public enterprises.

This argument was not very convincing when it was first raised and it is even less convincing now in the light of relevant evidence from the 1980s. Although enterprises such as British Steel and British Coal have not been allowed to go bankrupt, there have been massive public sector programmes of plant closure and employment reduction. Moreover, the major defeats suffered by trade unions over the past decade have been concentrated in the public sector. The budget constraints on state-owned enterprises have been hard indeed.

It is also very important to note that private ownership does not inevitably lead to financial pressures on enterprises that are equivalent in their effects to hard budget constraints. The privately owned companies may be monopolies and trade unions may be able to share in the monopoly rents of these enterprises. In addition, there are abundant examples in market economies of government support being provided to ailing, privately-owned enterprises (similar to a soft budget constraint in a state-owned enterprise).

Evidence on the effects of privatization on real wages is difficult to obtain because of absence of relevant published data. *The evidence that is available, however, does not indicate that real wages have been in any way adversely affected by changes in ownership* (see Table 3). If anything, the data point the other way, toward some gains in real wages.



Workers have also benefitted from schemes that have offered them shares in their enterprise on particularly favourable terms. The most outstanding example is the National Freight privatization, in which employees of the company were allocated *all* the ordinary share capital of the company at a discounted price. In addition to financial benefits, therefore, employees of the company were (collectively) given full *control* of the enterprise. The subsequent rewards of the employees have been spectacular (see Table 4).

#### 9. Privatization at the local government level

The aspect of the British privatization programme that has attracted most international attention has been the sale of enterprises "owned and controlled" at the level of central government. *There is a strong case to be made, however, for the proposition that it is privatization at the local government level that has had, and is having, the more substantial effects on economic behaviour.*

For example, throughout the 1980s there was a programme in which local authority (i.e. publicly owned) housing stock was sold to tenants at discounted prices, with the magnitude of the discount increasing with the length of the tenancy. By this means incentives for improving the housing stock have been greatly increased and there have been additional benefits in the form of reductions in some barriers to labour mobility (excess demand for public sector housing, resulting from price controls, had led to a system of rationing by means of *local* waiting lists which discouraged migration from area to area). Sales of public sector housing have also been very popular politically although, at the time of writing (March 1990), there has been some backlash due to high interest rates which are adversely affecting those who borrowed heavily (relative to their income) to purchase a house.

Another important dimension of privatization has been the transfer to the private sector of productive activities that were previously carried out by local government authorities. In many cases the local government body has retained responsibility for organizing the supply of the service to the community (e.g. in respect of refuse disposal) but has effectively sub-contracted the whole or part of service provision to private enterprise.

The effectiveness of this type of *contracting-out* arrangement depends in part on the nature of the commodity or service being provided. Relevant questions include:

Is it relatively straightforward for the local authority to monitor compliance with quality standards set out in the contract?

Can the existing producer easily be replaced in the event of a failure to comply with the contract?

Where the answers are in the affirmative *contracting out offers potentially large benefits because it is a method of replacing monopoly with competition.* Thus, the local authority can arrange *competition for the contract* by, for example, inviting tenders from a number of different potential suppliers.

Because the competition here has to be "managed" by the local authority it should be noted that performance will continue to depend in large part on the latter's commercial skills (although the relevant skills may be somewhat different from those required for efficient public production). Nevertheless, *the available evidence supports the hypothesis that substantial performance improvements can be achieved via this method.*

#### 10. Concluding comments: the state and the market

The situation currently facing reforming socialist economies is without historical precedent. One thing you can be sure about is that there is no ready-made model from other countries that you can adopt easily. Experiences such as that of Britain (with privatization) can be of help in clarifying basic economic principles, priorities and trade-offs. As to the application of those principles, however, Polish problems will require Polish solutions. And, because of your pressing need to address those problems,

it can confidently be predicted that you will enjoy a period of great intellectual advance along with a period of political ferment.

While the tasks are Herculean, the prizes also are great. Because of the system-wide nature of the reforms that are being implemented you will have opportunities to go well beyond the achievements of privatization programmes in the West. Success will, however, depend partly upon having a clear, strategic view of the way forward, if not of the final destination itself. Thus, one of the reasons why major changes occurred in Britain in the 1980s -- and, hence, indirectly why I am here today -- was the possession of such a strategic view by Margaret Thatcher. It is therefore highly appropriate that the title of this lecture refers to "Mrs Thatcher's" (rather than "Britain's") privatization programme.

I have emphasised a number of specific weaknesses of the British programme -- most notably the implications of the undue weights given to financial and redistributive objectives -- which I hope will carry some lessons for you. At this concluding stage, however, I would also like to draw attention to two underlying philosophies that have surfaced from time to time in the British debate. I believe that both are wrong and that both are potentially damaging to good policy making.

The first philosophy is that idealization of market processes associated with "strong" versions of the invisible hand theorems. On this view competitive markets are seen as leading quickly to some sort of optimal social equilibrium, and the elegance of the associated mathematics can exercise a magnetic effect on the intellectual mind.

The real world is not like that. Market processes are often messy: outcomes can be both inefficient and unfair. *The soundest argument for markets, therefore, is simply that, very frequently, they are the least bad of the alternatives.* To paraphrase Churchill's remark on democracy, markets are the worst method of resource allocation, except for all the others that have been tried.

The second philosophy one that sees privatization and related policies as part of a process leading to a massive withdrawal of the state from economic activity. This can be viewed as the free-market analogue of communism's promise that the state would wither away, and I believe it has about the same prospect of success. In Britain, for example, although there has been a definite retreat by the state from the supply side of the economy, government expenditure after 11 years of Mrs Thatcher still accounts for nearly 40% of gross domestic product (the figure was 43% in 1979).

Even after a successful transition to a market economy, it is almost certain that the state will continue to play a large role in the economic life of your nation. In some areas, indeed, its role will grow. The most obvious example is in the field of environmental regulation where, in addition to local, regional and national pollution problems, we are all faced by global threats connected with phenomena such as the greenhouse effect. Largely because of the infeasibility of defining appropriate property rights, markets alone cannot be relied upon to solve these problems.

In my view, the fact that the state will have much to do in the way of economic policy *strengthens* the argument for rapid withdrawal from those activities where markets can be expected to be superior. *This will allow government resources to be concentrated on a narrower range of issues, and the resulting focusing of policy making should facilitate better performance.*

This potential gain has not been fully realised in Britain, in part because of the tendency of successive Thatcher Governments to over-stress the virtues of markets and to over-stress the vices of the state. As implied above, the result has been unrealistically high expectations concerning the effects of privatization and, more importantly in the longer term, a failure to develop effective governmental strategies in the many the areas of economic activity where "interventionist" public policies continue to be practised.

Table 1. Pricing of shares (values in £)

Company	Gross	Offer	First	Opening	% gain	Value of
		proceeds	price	instalment	price	gain
BT	3,900m	1.30	0.50	0.93	86%	1,290m
Trustee Savings Bank	1,360m	1.00	0.50	0.85	70%	476m
British Gas	5,600m	1.35	0.50	0.625	25%	518m
British Airways	900m	1.25	0.65	1.09	68%	317m
Rolls Royce	1,360m	1.70	0.85	1.47	73%	496m
British Airports	920m	2.45	1.00	1.46	46%	172m

Source: Financial Times.

Table 2. Costs of major assets sales

Company	Expenses (£ million)	Expenses as a % of proceeds
Cable and Wireless	7	3.1
British Aerospace	6	3.8
Amersham	3	4.6
Britoil	17	3.2
Associated British Ports	2	11.2
Enterprise Oil	11	2.8
BT	263	6.8
British Gas	360	6.4
British Airways	42	4.7

Source: National Audit Office.

Table 3. Percentage increases in average real wages/salaries  
(year zero = year of privatization).

	Year 0	Year 1	Year 2
British Aerospace	-0.4	9.0	4.6
National Freight	-	8.6	4.1
Britoil	-	5.0	3.8
ABP	3.5	2.5	0.9
Jaguar	6.6	7.4	8.4

Source: Company Accounts.

Table 4. National Freight's share price (£)

1982	1984	1985	1986	1987	1988	1990 (March)
0.05	0.16	0.35	0.78	1.35	1.75	2.23

Sources: Company Report and Accounts; Financial Times.

## PRIVATIZATION, THE STOCK MARKET AND SHARE OWNERSHIP: TOWARD PRACTICAL SOLUTIONS TO NEW PROBLEMS

### 1. Introduction: the "paradox of privatization".

I have stressed in the earlier lectures that privatization *per se* is only one aspect of the process of creating a more market-based economy. Nevertheless, where reasonably effective competition in the relevant markets either exists or can be expected to emerge, evidence and experience point to the conclusion that, in reforming socialist economies, the contribution of privatization to improving economic performance is potentially considerable.

There is, however, a snare standing in the way of attempts to unlock this potential. It arises from the fact that *the process of privatization is an activity of the state sector itself*. This leads immediately to the paradox of privatization: *state inefficiency is simultaneously a motivation for and impediment to effective privatization policies*. Further, *the impediment is likely to be greater the more complex the tasks that public policy is required to accomplish*.

Whereas the potential gains from privatization are much greater for countries in transition from socialism than they have been in Britain, it is unfortunately also the case that potential for mistakes is correspondingly greater. In particular, the more the state tries to manage the detail of the process of economic restructuring the greater this second danger will become.

### 2. The pace of the transition

The privatization paradox is, I believe, very relevant to the question of how quickly the transition to new forms of ownership should be made. Discussions of various schemes of privatization have tended to focus upon technical aspects of the different proposals, but there is a danger in this that central issues will be forgotten.

Consider, for example, proposals that involve a steady, but slow, drip-feeding of enterprises to the private sector, perhaps spread out over a period of two decades or more. Such a process would have the advantage of allowing for the gradual build-up of private sector wealth, so that shares in companies could be sold to domestic nationals at prices that reasonably reflected underlying values.

On the other hand, *a gradualist policy will imply that, over a relatively lengthy time period, the privatization process will continue to be subject to the vagaries of changing political forces*. We know from the study of state activity how frequently this involves the redistribution of income, wealth and power from one group in society to another, and how this attendance to special interests can lead to system-wide inefficiencies that add to the inefficiencies arising more directly from bureaucratic control.

Given that in most gradualist schemes state-owned enterprises would continue to account for a very substantial fraction of economic activity for many years to come, there would be considerable scope for the privatization process to be hi-jacked by vested interest groups, to the ultimate detriment of large sections of the population. Moreover, the slower the privatization process the higher the present value of the costs arising from deficiencies in the framework of monitoring and controlling public enterprises.

### 3. The creation of intermediate institutions

One possible way forward, which has as an objective the alleviation of the dilemma under discussion, relies on the creation of "intermediate" institutions such as holding companies or investment banks. After transforming enterprises into joint stock companies, for example, some schemes suggest that the resulting shares (less perhaps some initial allocation to workers) should be transferred to these new institutions.

If the holding companies or investment banks themselves continue to be owned by the state, this process can not, of course, be described as privatization. Nevertheless, the argument is that the managers of the intermediate institutions would be independent of the state bureaucracy and able to pursue the objective of increasing enterprise efficiency in ways that were less hindered by political pressures and bureaucratic constraints. And, of course, over time the holding companies or investment banks could sell enterprise shares in private capital markets so that, at some point, a given enterprise would truly be privatized.

While I will argue later that the creation of intermediate institutions could be an eminently sensible aspect of the privatization process, there are some grounds for concern about schemes that involve the retention of these organizations within the state sector. For example, it can be questioned whether the managers will indeed have the autonomy envisioned. On the other hand, if they do have such autonomy, there is a problem connected with managerial incentives and accountability. This is the old question: *who guards the guardians?*

To illustrate, suppose a holding company requires capital for enterprise restructuring. As the ultimate owner the state may have difficulty in credibly committing itself to not exercise its influence on major decisions involving the allocation of investment funds (particularly in what might be a fast-changing political situation). If, however, the central government did succeed in making such a commitment the result might simply be substantial managerial discretion, *which is just another form of monopoly power.*

As implied by the arguments and evidence in the earlier lectures, an important principle of public policy is that opportunities for the exercise of only weakly constrained power should be minimized. The creation of state-owned intermediate institutions would violate this principle by leaving large amounts of power with either the central government (exercising rights arising from ownership claims) or the institutions' managements (exercising rights arising from delegated control).

#### 4. The policy sequence

One of the underlying features of a number of the gradualist proposals for privatization appears to be an assumption that it is either necessary or desirable to create a capital market before transferring enterprises to private ownership. And, given the time that is expected to elapse before the bulk of existing enterprises are firmly in the private sector, this sequence also tends to imply that much enterprise restructuring (such as closure of some plants and concentration of production in others) will be undertaken prior to privatization.

My own view, however, is that the prior existence of a sizeable capital market is certainly not necessary for privatization, and that the arguments for following the indicated sequence (establishment of capital markets first, privatization second) are far from compelling. Indeed, to some extent this involves putting the cart before the horse: it is perhaps better to think of privatization as one means by which a domestic capital market can be created.

The key underlying point is that "markets" are not institutions established by governments. They emerge naturally as the result of free interactions among economic agents. All that is required for the creation of a market is that:

- (i) individuals and/or enterprises have the necessary means of trade, and
- (ii) the freedom of individuals and/or enterprises is not constrained by coercive state intervention.

To create a capital market in claims on productive assets, then, all that is required is the legal existence of such claims (that is, the necessary property rights) and the freedom to trade in such claims. Elaborate state guidance is not required and, although a framework of financial regulation will be a desirable feature of the market environment, there is again no reason why the creation of capital markets should await the development of a highly sophisticated regulatory system. That is not, after all, how institutions have developed and evolved in the market economies of the West.

## 5. Problems with rapid privatization

A more substantive objection to rapid privatization is that the demand for shares would be insufficient to absorb new issues at a rapid rate, except at very low prices. Hence, the state would receive little revenue from the privatization process. The problem might also be exacerbated by an insufficiency of resources to handle technical flotation issues at a rapid rate.

It should be noted, however, that this objection is only a strong one if it is indeed the case that raising substantial revenues for the state is a principal aim of privatization. One of the lessons of the British experience is that this revenue raising objective can come into conflict with other objectives of privatization. In Britain, the objective that was downgraded because of this conflict was the promotion of competition. That could happen also in Poland, although I suspect that the main danger here is that the whole process of economic transformation could be delayed.

If, on the other hand, raising finance for central government via sales of state enterprises is not a high priority then the level of the share price is irrelevant except in so far as it affects the distribution of income and wealth. And, given that there is a strong case for free distribution of newly created property rights to the people as a whole, *economic justice and rapid privatization would appear to go hand in hand.*

A more difficult issue that arises in the event that shares are freely distributed or are sold at very low prices is the potential effect on aggregate demand. A surge in consumers expenditure triggered by a rapid increase in personal sector wealth and liquidity would be unwelcome from the perspective of short-run macroeconomic stabilisation.

Again, however, I would caution against giving too much weight to this point. There always exists a temptation for central governments to widen the range of policy instruments used to combat short-run demand management problems, even when those instruments have damaging longer-term effects on the supply side of economic activity (price controls are a good example). Unless the use of standard instruments of monetary and fiscal policy is severely constrained for some reason, it is generally better if this tendency -- which is usually driven by short-term considerations -- is not allowed to interfere with supply side policies. This is particularly important in that it is not clear that the effects of rapid privatization on aggregate demand will necessarily be large (see point 10 in section 9 below).

Another objection to rapid privatization is that many enterprises are not, in their current forms, viable as private sector companies. On this argument restructuring of companies should *precede* privatization, as in the cases of British Steel and British Coal.

The argument has much merit, and there are no doubt large numbers of enterprises for which the point is correct. There are also large numbers of enterprises that *would* be viable immediately and for which the point is largely irrelevant. More important, if enterprises are privatized in blocks (or portfolios) there is no reason why loss-making units should not be transferred to the private sector, leaving restructuring decisions to be made later by its new owners (at any point in time most large companies engage in some loss-making activities).

Finally, it can be objected that rapid privatization would, in current conditions, lead to the replacement of public monopoly with private monopoly, leading only to limited benefits in terms of economic performance. This is, in my view, the most substantive criticism of the policy.

Accepting the strength of the point, however, an alternative conclusion is possible, namely that moves to increase competition should themselves proceed at a rapid pace. And, fortunately, there exist policy instruments that are capable of achieving this outcome. A large slice of domestic production is accounted for by tradeable goods. *Liberal trade and exchange rate policies are, therefore, capable of producing a rapid increase in competition across a whole range of economic activities.* Indeed, given structural imbalances in the economy, it is possible to envision circumstances where competitive pressure increases too quickly, rather than too slowly.

There also exist many non-tradeable goods and services markets where it is realistic to expect fairly rapid increases in the level of competition, particularly in service sectors where small firms are able to survive

and prosper. In these areas domestic anti-trust policy should replace trade policy in the mix of economic instruments. That is, thinking in terms of the headings of "ownership", "competition" and "regulation", the appropriate policy mixes might be:

*privatization + anti-trust + de-regulation* for non-tradeable goods and services, and

*privatization + liberal trade policies + de-regulation* for tradeable goods and services.

It is where product market competition is much less easily increased -- in public utility networks, for example -- that the case for a more gradualist privatization policy is strongest. I would not, therefore, recommend rapid privatization of electricity and water distribution networks. Even acknowledging the size and importance of these sectors, however, there remain large numbers of enterprises that are candidates for very early privatization.

## 6. Capital markets and the control of enterprises

Before going on to consider possible schemes aimed at achieving a rapid process of privatization, it will at this point be useful to stress the conceptual distinction between the market for financial claims on enterprises and the market for control of those enterprises. Thus, an ordinary share in a British company typically carries a *bundled* package of rights made up of:

- (i) various financial entitlements (e.g. to dividends), and
- (ii) the right to cast one vote at shareholders meetings.

The reality of the distinction becomes apparent when it is noted that some companies issue ordinary shares carrying voting entitlements different from the standard one vote per share. Because of its place in the privatization programme, National Freight is the best known example: shares in the company that are held by its employees carry twice the voting rights of shares held by other persons.

National Freight is, however, not unique. Inspection of the list of UK quoted companies indicates the existence of a non-trivial number of companies that issue two types of ordinary share, each of which carries different voting rights but similar financial entitlements. The two types of share typically trade at different prices and the price differential between them can be used to calculate the market value of voting rights. *This represents a price in the market for corporate control.*

The distinction is stressed here because, in my view, the issues surrounding the various options that are available in respect of enterprise control are much deeper than those surrounding the privatization of financial claims. It is, therefore, important for clear thinking that the distinction be kept in mind. Further, there is some element of choice as to how the two conceptually distinct markets are fitted together: neither Poland nor any other country is constrained to follow the "one vote per ordinary share rule" (although there do exist strong arguments in favour of this standard bundling of rights).

## 7. Workers' rights of control

In particular, it would be perfectly feasible to grant existing workers in an enterprise privileged positions in respect of the control of that enterprise without simultaneously requiring that workers hold all, or even the majority, of the ordinary shares. Given that ownership of property rights in financial claims on the enterprise can be separated from rights of control, worker self-management can, at least in principle, be combined with a familiar type of capital market in respect of financial claims.

The standard objection to this type of arrangement is that control of the enterprise can be used to divert income/wealth away from ordinary shareholders as a whole and toward the sub-group of controlling shareholders. At the most basic level, for example, control could be used to increase wage rates in the enterprise at the expense of profits. If, therefore, the self-management option is to be pursued within a legal framework of joint stock companies, mechanisms to protect "minority" shareholders will be required.

Note, however, that protection of minority rights is in any case a desirable component of company law. In a standard form of joint stock company (with one vote per ordinary share), for example, the acquisition of a 51% stake by one person can give rise to opportunities for effective expropriation of the income/wealth of the minority. The "expropriation" problem is inherent in the coercive aspects of majority voting procedures, and is not therefore specific to self-management schemes.

Account should also be taken of the fact that in market economies a substantial proportion of finance for enterprises is supplied in the form of debt capital which carries no voting rights. In this case, protection from expropriation is achieved by contractual commitments: the enterprise guarantees a given stream of interest payments and guarantees to redeem the debt at a specified date. Failure to meet these commitments leads to default and to the triggering of procedures that lead to changes in the control of the enterprise.

A second way in which holders of non-voting shares can be protected, therefore, is via initial contractual commitments that assign to shareholders rights with characteristics that are normally associated with debt capital.

#### 8. The tradeability of voting rights

If self-management options *are* pursued most important single pitfall to avoid is *entrenchment of voting rights*. By entrenchment I mean a situation in which voting rights cannot be traded. For, in that event, a *market* for corporate control will not, by definition, have been established.

Provided, however, that voting rights can be traded in one way or another, workers holding such rights will at least be faced with their opportunity cost (that is, there will be a market price for the rights). Suppose, for example, that workers in an enterprise held 10% of the ordinary shares of the company but that these shares carried a majority of the votes. Then, if the control premium was 10% -- which means that an outside interest would be willing to pay 10% above the present value of the firm's (anticipated) financial returns to acquire control -- workers could collectively double the financial value of their shares in the company by selling voting control.

As before, therefore, the key requirements of policy are the establishment of the *means* of trade and the *freedom* to engage in trade. The initial *distribution* of property rights, whether they be rights to votes or to financial entitlements, is an important aspect of public policy but it is not necessarily a crucial factor in determining the effectiveness (in terms of efficiency) of the resulting markets.

#### 9. An outline scheme

There are many possible ways of achieving rapid privatization and there are no shortages of hypothetical schemes (economist are as keen to differentiate their products as any marketing department). I therefore offer the following outline proposal with some reluctance. Nevertheless, since the title of this lecture contains the words "toward practical solutions", failure to provide an illustration of how principles can feasibly be turned into practice could reasonably be viewed as evasion of a major issue.

I would stress, however, that what follows is designed largely for illustrative purposes (i.e. to show what could be done). It should, for example, be noted that, while the proposals are put in numerical form (simply because algebraic formulations are more tedious to follow), there is nothing particularly significant about the precise values of the numbers that have been selected. Thus, initial allocations of shares to workers might be 20% instead of 10%.

With these points in mind the suggestions are as follows:

1. Commence turning enterprises into joint stock companies.
2. Create a series of, say, fifteen investment trusts (intermediate institutions) in joint stock company form and divide them into three groups.



3. Allocate each adult citizen a number of shares (say 100) in each of three investment trusts, one from each group.

*This might be done regionally, so that all citizens in a given region held shares in the same three trusts.*

4. Select enterprises for privatization on the basis of the state of competition (actual and potential) in their product markets.

*Where competition is extremely limited and cannot quickly be increased early privatization should not be a priority.*

5. Distribute 60% of the share capital of any enterprise being privatized equally among the (five) investment trusts in a given group.

*For each "flotation" the group could be chosen so as to ensure that any particular group did not monopolise ownership in a particular industry or sector. The effects of this procedure are that (i) the "initial" portfolios of all trusts in a given group are identical but different from those of trusts in the other groups and (ii) every adult citizen has an identical initial claim on the market portfolio.*

*Because the initial portfolios of trusts in a given group are the same it would immediately be possible to construct league tables showing the comparative performance of their various managements. This would facilitate the development of incentives for the trust managers to seek to maximize financial returns.*

6. Investment trusts are required to act as market makers, trading on their own accounts at posted buy and sell prices.

*The buy/sell spreads and corresponding volumes offered would be subject to longer term scrutiny of the anti-monopoly agency, but might initially be regulated for a predetermined period. The effect here is immediately to create a market in company shares.*

7. Trade in the resulting market is unrestricted.

*Thus anyone can buy and sell, including foreign and domestic individuals and institutions as well as the investment trusts themselves.*

8. Each investment trust is required to value its portfolio weekly and to publish the value of assets backing each of its own issued shares (held by the general public).

*Thus citizens would be able to check on the underlying value of their holdings in the trusts and, as more and more companies are privatized, they will see the values of those holdings increasing steadily.*

9. Holdings of shares in the initial investment trusts are restricted to Polish citizens.

*This is necessary because the share capital of enterprises is being given to the trusts.*

10. Shares in investment trusts can be bought and sold only after some initial period (e.g. one year for trusts in group one, two years for trusts in group two, and three years for trusts in group three).

*This would guarantee some initial, but limited, "learning period" to hinder exploitation of ignorance. Coupled with point 9, it also has the effect of (i) preventing erosion of the individual shareholding base in the economy and (ii) limiting the effects of share distribution on consumers' liquidity (and hence on aggregate demand).*

*Another option would be to make shares in investment trust companies non-tradeable. This can be regarded as the market socialism solution, in contrast to the people's capitalism solution which allows the shares to be traded.*

11. When an enterprise is to be privatized, the workers may choose one of two types of company constitution:

Type S, the a standard joint stock company form, or

Type W, a self-management form of joint stock company.

*This, together with the following points, is designed to show how privatization can proceed under different initial allocations of "rights of control".*

#### Type S

12. All shares in type S companies carry one vote.
13. Workers in a type S company are allocated 20% of the ordinary shares. The remaining 20% is held by the state.

*The state will able to raise revenue by selling this stake once active capital markets have been established. Note that workers will have an additional beneficial stake in the enterprise through their "citizens" holding in investment trusts.*

#### Type W

14. For type W firms, ordinary shares are divided into two classes:

Class A, amounting to 90% of the total and carrying one vote per share, and

Class B, amounting to 10% of the total and carrying ten votes per share.

15. Class B shares are divided among workers in the company. 67.5% of class A shares are allocated to investment trusts and 22.5% to the state.
16. Trade in class A shares -- initially held by investment trusts and the state -- is unrestricted.
17. Class B shares can only be held by workers and former workers in the company.

*This ensures that this group always possesses a majority of votes.*

18. The company constitution can be changed, but (with one exception, set out in 19) only by a majority vote of both classes of share.

*This is the crucially important point that establishes a market in corporate control, since it effectively allows workers, as a group, to trade their rights of control.*

19. Workers have the right to transform each class B share into 2.25 class A shares upon a majority vote of class B holders.

*That is, the workers have an option to transform a type W firm into a type S firm at any time.*

20. To protect against "oppression of the minority" class A shareholders are entitled to a minimum dividend payment each year.

*This gives class A shares in type W companies some "debt-like" characteristics. The first dividend might be based upon an initial estimate of asset book values and revalued thereafter in line with some relevant index. (Note there is some similarity here with the existing Polish dividend tax.)*

21. Failure to meet the minimum dividend payment would trigger automatic restructuring into a type S company.
22. Minimum dividend entitlements have priority over unsecured debt. Borrowings secured on assets of the company can only be made with the approval of a majority of class A holders.

*This provides further protection for the "minority" shareholders.*

#### 10. Comments on the scheme

The above type of scheme would appear to have a number of desirable characteristics in the context of the situation facing reforming socialist economies, including:

1. Privatization of enterprises in the many sectors of the economy where reasonable product market competition is easily achieved (e.g. via liberal trade policies) could occur at a rapid pace, thus reducing the burden of decision making on overstretched central government departments.
2. It satisfies notions of social justice in that (i) it distributes assets equally among the population and (ii) it is consistent with the view that the people are already the owners of the relevant assets.
3. A wide political base would be created for the transformation of the economy. Unlike in, say, Britain, where initial financial gains were concentrated in a small section of the community, the population as a whole would see their assets increasing in value over time.
4. A capital market in ordinary shares would be created immediately and simply.
5. Potentially considerable transactions costs associated with share issues could be avoided. Thus, for example, the situation in which foreign financial institutions were paid large sums of money to sell Polish assets to Polish citizens would not occur.
6. The costs of distributing documents to the population are minimized by keeping the relevant claims very simple (each citizen would effectively hold shares in only three investment trusts). Moreover, if the tradeability of the investment trust shares was initially restricted, there would be no necessity to get the relevant papers to every citizen immediately. (Once the entitlement was established, any individual could begin to track its value and delays in relevant paperwork would not be a major issue).
7. Flexibility is established in respect of the initial control of enterprises. Nevertheless, workers will always be faced with a "market price" of control in that they can increase their financial wealth by relinquishing control (either by obtaining more shares in their company or by accepting an outside offer for their initial shares).
8. Incentives to trade control exist both for enterprises that perform well and for those that perform poorly. Good performance will tend to raise the value of the option to double workers' shareholdings, while poor performance will lead to pressures to release the minimum dividend constraint.
9. Enterprise restructuring initiatives will come from "below" (rather than from the state) and may arise in a number of ways. Examples of triggering events could include:

A type W firm is unable to meet its minimum dividend commitment.

A capital injection is required.

Another firm makes a takeover offer.

## 11. Conclusions

I have ended up by outlining a set of proposals that are far more radical than anything that has yet been attempted in privatization programmes elsewhere in the world, including Britain. While it is appropriate to repeat the point that these proposals are intended simply to illustrate one type of option that is available, it is almost inevitable that the suggestions will give rise to immediate questions concerning feasibility

These are, however, questions for you rather than for me, in that much depends upon the balance of political forces and the characteristics of the particular individuals holding key posts in your government. All I *would* say is that it is by no means always the case that less ambitious programmes are more easily implemented than more ambitious programmes. Thus, a slow pace of reform may fail to develop the political momentum required to keep a given programme moving steadily forward.

The crucial issues are, I believe, more to do with the objectives of the programme than with feasibility, which, it may be noted, is a rather elastic concept: *options are sometimes classified as infeasible in order to obscure the fact that policy makers are pursuing real objectives that are at variance with their nominal objectives.* And the key point here is the one made at the end of section 6 (political advantage and social justice) of the second lecture. *If the revenue-raising objective of privatization is given a low priority then it will be possible for Poland and its neighbours to make a speedy transition to a market economy based largely, but not exclusively, on private ownership. Moreover, the transition can be made in a way that avoids regressive redistributions of wealth.* That is, the opportunity exists to create a market economy characterised by a highly unconcentrated distribution of share ownership. If that opportunity is taken the result will be an advance on anything yet achieved in the West.