Advanced Corporate Management

Private versus Public Enterprise

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Private versus Public Enterprise

- Common Elements
  - Produce goods and service for sale
  - Revenues related to costs
- Distinguishing Elements
  - Public enterprises are state owned (SOEs)
  - Ownership compulsory for taxpayers
  - Ownership non-transferable
  - Residual claimants have a diffuse interest
  - This interest cannot be captured by superior managers
  - Public ownership typically heterogeneous

Private versus Public Enterprise con’td

- Distinguishing Elements (con’td)
  - Government represents many different groups
  - These groups have diffuse and conflicting interests
  - Governments give special privileges to SOEs
  - These privileges arise from regulation, taxation, ownership per se, credit backing
  - SOEs may have non-commercial obligations placed on them
  - Private enterprises typically have a single homogeneous interest
  - They also typically receive less Government preferment

SOEs: Characteristics

- Commercial and non-commercial objectives
- Multiple and often conflicting non-commercial roles
- Erodes focus on commercial objectives
- Statutory objectives: deliberate choice
- New Zealand transparency arrangements for SOEs are unusual
- And they are being eroded too
- Associated problem: weak taxpayer interest in commercial performance
- Government's powers to intervene in governance, eg, Boards, remuneration
- Changing government/owner requirements

International Evidence on SOEs

- Mixed objectives remarkably persistent
- Diversity of non-commercial objectives considerable
- Public ownership does not benefit diffuse interests, eg, the poor or environmentalists
- Beneficiaries tend to be concentrated interests within the enterprise, eg, employees, suppliers, consumers
- These beneficiaries gain at the expense of the taxpayer
- Government intervention can be in governance, management, strategy, operations, etc

Is this all logical

- The logic that SOEs face multiple, conflicting and persistent objectives arises from the fact that their owner, the Government, faces multiple and conflicting and ever-present interests

- The real difficulty is not one of multiple objectives but of plural principals

Special Privileges for SOEs

- Diverse forms of privilege
  - Protection from competition
  - Enforced monopolist
  - Underpriced natural resources
  - Tax exemptions
  - Lower financing costs
  - Reduced dividend requirements
  - Lack of transparency
  - Absence of takeover threat
- Trade-off can be imposition of non-commercial objectives
- These can be explicitly or implicitly linked to special privileges
- Economic rents arising from privileges can thus pay for non-commercial objectives

Private Enterprise

- Private companies can also be subsidised or regulated
- If private firms are superior at meeting commercial objectives, why not
  - assign them privileges
  - assign them non-commercial goals
  - ensure the first compensates the second
- Why do legislators prefer SOEs?

Preference for SOEs

- Difficult to agree with private firms on non-commercial objectives
- SOEs redistribution less transparent
- Residual claimants in public enterprises typically weaker than private company shareholders
- Changes in privileges easier with SOEs
- SOE seen as more legitimate recipient of privileges
- Cost of capital explicitly higher for private company reliant on public privileges because of risk of losing privileges
- Risks around durability of privileges
- Statutory monopoly easier to sustain than private monopoly

SOE Activities

- SOEs typically found historically in post, electricity, gas, railways, telecommunications, airlines
- Common industry characteristics
  - SOE large share of output
  - Capital intensive
  - Capital sunk, network orientation
  - High forward linkages (output used by other industries)
  - Produce standard product
  - Absence of large number of decentralised establishments
- All these create pressure for government intervention

Some Questions

- What explains this type of SOE concentration in certain activities
- What prompts such heavy government intervention in these industries?
- Why do governments choose public enterprise rather than other means of regulation?
- Three approaches to these questions
  - Welfare maximisation
  - Political economy
  - Transactions costs

The Welfare Maximisation Approach

- Theory suggests legislators make choices based on pragmatic rational welfare maximisation

  ie, when welfare benefits exceed costs
- Benefits arise from market failure, ie, the competitive problems of dominance
- Costs arise from organisational failure, ie, the failure of SOEs to minimise the costs of production
- Thus SOEs are chosen when problems of market failure dominate those caused by organisational failure

Empirical Evidence

- On welfare maximisation approach, evidence is mixed
- When ownership effects are separated from effects of regulation and inadequate competition, private enterprise is typically more efficient than public enterprise
- But with non-competitive regulated firms, evidence is not clear cut
- This indicates that market dominance and the competition problems associated with it, is not by itself a sufficient reason to explain the use of SOEs
- See Murray J Horn, The Political Economy of Public Administration, Cambridge University, 1995, for a summary of references on empirical evidence

The Political Economy Approach

- These arguments assume SOEs are largely the outcome of distributional politics
- SOEs are preferred to other approaches (eg, regulation) because the redistribution achieved is less transparent
- Where SOEs dominate in weak competition industries, the invisible “surplus” can be used for non-commercial objectives
- In capital intensive activities this surplus can be achieved by running down capital
- SOEs are thus rare in competitive activities because competition drives out “slack” or “surplus”
- But SOEs can be used to create low visibility redistribution in most activities by creating an SOE and extending special privileges to it

The Transactions Costs Approach

- Four main costs:
  - Decision making and private participation costs
  - Uncertainty costs
  - Commitment issues
  - Agency costs

Decision Making Costs

- Decision making costs high when it is difficult to reach agreement on legislation
- Tension between commercial and non-commercial objectives often left unresolved in legislation
- Easier to create SOEs than to agree their priorities
- More likely to see SOEs where there is conflict over objectives and where beneficiaries sustain ongoing interest in the management of the SOE

Uncertainty Costs

- There is uncertainty around the costs of non-commercial objectives
- In SOEs, risk borne by taxpayers rather than private shareholders
- Government's incentive is to reduce cost of uncertainty by allocating risks to groups well placed to spread risk
- Taxpayers are diffuse and poorly placed to influence management of SOEs

The Commitment Problem

- Government cannot commit itself NOT to increase regulation
- This implicit threat is costly to private enterprise
- Creates uncertainty about future profitability and investment
- It creates the possibility of surprises and attenuation of property rights which markets dislike
- Threat of exappropriation
- How important is this threat in explaining public ownership in particular industries?

  ie, those that are capital intensive, single firm dominated, have high forward linkages
- Note the role of political ideology

Agency Costs

- Agency costs are the costs of ensuring the desired distribution is achieved and the loss is associated with managers acting in their own interests
- These two factors pull in opposite directions
- SOE managers may be more responsive to the beneficiaries of any SOE distributional effects and less responsive to the residual claimants (the taxpayers)
- Profit-seeking creates an incentive to avoid non-commercial objectives
- Monitoring SOE managers much more difficult than private sector managers (eg, no share price, diffuse ownership)
- SOE managers better able to act in their own interests?

Agency Costs con’td

- Legislators have an incentive to:
  1. Prefer private enterprises
  2. Prefer SOEs when non-commercial objectives are very important
- When will agency loss to SOE managers be large?
- Depends on discretion given to managers, degree of competition in the industry, extent of regulation and non-commercial objectives, etc

Industry Characteristics

- Arguments used to favour public enterprises encompass several elements of transactions costs
- Agency costs may favour SOEs when non-commercial objectives are very important and when the agency loss to management is small
- Commitment costs or political uncertainty favour SOEs where there is a concentrated political interest in non-commercial objectives and where a surplus can be created to finance a redistribution
- Legislative decision making costs favours SOEs where there is conflict among private interests thus facilitating vague legislation and a dependent administrative agent
- SOEs typically have large output shares, high forward linkages, capital intensive, standard products

Privatisation

- Welfare maximisers would privatise if “market failures” associated with private firms had become less serious or if organisational failures of SOEs had become more obvious
- Political economy arguments for privatisation rests on either the amount of slack or surplus reducing or SOEs transfers becoming more visible
- Transactions costs arguments for privatisation arise as it becomes apparent that SOEs are poor agents for taxpayers and creditors, when a wider set of reforms is being undertaken (commercialise, deregulate, privatise), when the ability to intervene is no longer seen as a virtue, and when SOE-type redistributions are seen as either too costly or too invisible

Reference:

Murray Horn, The Political Economy of Public Administration, Cambridge University Press, 1995.

Graham Scott, Public Management in New Zealand - Lessons and Challenges, New Zealand Business Roundtable, 2001