OWNERSHIP, EFFICIENCY AND THE MODERN ENTERPRISE: A THEORETICAL PERSPECTIVE

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ABSTRACT

In this dissertation, public and private ownership is compared on the basis of allocative and productive efficiency. At the outset, it is shown how the traditional advantage of owner-managed private firms over their public counterparts in respect of productive efficiency is weakened by the presence of allocative inefficiency in the private sector, due to market failures such as imperfect competition. The case of the natural monopoly is especially important, because there is no scope for improving allocative efficiency by increasing competition. Governments attempt to address this problem by regulating or nationalising these monopolies and then enforcing a policy of managerial cost pricing, albeit at the expense of productive efficiency. However, the gains in allocative efficiency are lessened by the use of public firms by politicians as political instruments to further their personal interest. As a result, public failures in the form of an over-supply of public goods are created. A compromise between the allocative inefficiency in the owner-managed private sector and the productive inefficiency in the public sector emerges with the rise of the private managerial firm. Distinctive characteristics of the managerial firm, such as the separation of ownership and control, provide the necessary incentives to reduce monopoly prices and expand output, thereby moving closer to the allocatively efficient position. Although productive efficiency is sacrificed to some extent in the process, the incentives inherent to private ownership ensure that the comparative advantage of the private managerial firm vis-à-vis the public firm is maintained. The net efficiency effect of the private managerial firm is therefore expected to represent a higher level of social welfare than that of the public firm.

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CHAPTER 1: INTRODUCTION

This dissertation is aimed at performing a comparative analysis of the economic consequences of public and private ownership in a modern economy. For this purpose we shall distinguish between allocative and productive efficiency and consider how their relative importance might vary with different patterns of ownership. The conventional rationale for public ownership, and thus for the rise of the public enterprise, derives from the perceived lack of allocative efficiency in the private sector, in the form of the undersupply and overpricing of goods and services.

Allocative inefficiency was supposed to be a characteristic feature of natural monopolies producing socially important goods and services. However, the growth of the public sector, introduced a different kind of failure, i.e. public failure, resulting in an oversupply of public goods. It will be argued that public failure was partly caused by factors inherent to public ownership such as the separation of ownership and control, the self-interested behaviour of politicians and bureaucrats, and the use of the public enterprise as a political instrument. While both the conventional private firm and the public enterprise brought about allocative inefficiency, albeit in different ways, the rise of the private managerial firm offered a potential solution by raising output to competitive levels as a result of the existence of contestable markets, and the pursuit of goals other than profit maximisation, e.g. sales maximisation and social responsibility.

Compared to the private sector, the public sector, furthermore, has a poor track record regarding productive efficiency. Possible causes thereof are escalating pressure from trade unions, the lack of managerial motivation and incentives, insufficient performance monitoring, too little spending on research and development, and rent-seeking costs. Although the concentration of ownership in the private sector may also give rise to productive inefficiency, we shall argue that private ownership, in the form of the modern managerial firm, is preferable to public ownership if the full effect on allocative and productive efficiency is to be taken into account.

At the outset it is important to explain the difference between allocative and productive efficiency and to state clearly what we mean by the organisational structure of the firm to be considered.

Allocative efficiency:

Black and Dollery (1992:2-3) define allocative efficiency broadly as an efficient allocation of scarce resources amongst alternative uses, giving rise to production of the optimal mix of commodities. Under perfectly competitive conditions, the optimal output mix results from consumers responding to prices which reflect the true costs of production, or marginal social costs. Allocative efficiency involves an interaction between the production capacity of the economy and the consumption activities of individual consumers. Allocative efficiency in the Pareto sense, would be attained in perfectly competitive markets where there are no uncertainties, externalities or increasing returns if and when the following three conditions are simultaneously fulfilled. Firstly, production must be efficient in the sense that no inter-sectoral re-allocation of resources could increase the output of any commodity without decreasing the output of any other commodity. Secondly, consumption must be efficient in the sense that no interpersonal re-allocation of commodities could increase the utility of any consumer without decreasing the utility of any other consumer. Thirdly, production and consumption efficiency must be achieved simultaneously.

Allocative inefficiency can present itself in different forms. A distinction can be made between consumer-driven and producer-driven inefficiency. Consumer-driven inefficiency could be caused by consumers acting collectively and insisting on too low prices and too high output levels. This cause, however, is not very common because of the free-rider problem as well as the usual absence of a strong solidarity amongst consumers. More common is the other extreme whereby allocative inefficiency is caused by the lack of consumer sovereignty and the inability of consumers to reveal their needs and preferences.

In this dissertation the emphasis will be placed on producer-driven allocative inefficiency. This firstly occurs in the event of a market failure, e.g. a concentration of market power or trade union pressure, enabling or forcing producers to raise prices above marginal cost and by reducing output below its optimal level. Secondly, such inefficiency also occurs where a public enterprise is obliged to lower its price and expand output in order to achieve certain social aims, or because of the presence of certain externalities.

Productive efficiency:

In respect of productive efficiency (also called operational or X-efficiency), Harvey Liebenstein (1966:407-413) contended that for a variety of reasons people and organisations normally work neither as hard nor as effectively as they could. He showed how the absence of strong competitive pressures reduces the incentive of firms to maintain full internal efficiency and instead allow their unit costs to rise above competitive levels. Firms therefore operate within the outer bound of the production possibility curve consistent with their resources. If, by reason of certain motivational factors, the work-force can be encouraged to work harder and release more energy, the firm could considerably improve what Liebenstein calls its X-efficiency. He argued that the pressures of competition would ensure the firm remains close to its production possibility frontier as determined by the chosen combination of resources and available technology. He also suggested that "many people will trade the disutility of greater effort, of search, and the control of other peoples' activities for the utility of feeling less pressure and of better interpersonal relations" (Liebenstein, 1966:407). Liebenstein believed that X-efficiency could be improved by promoting competitive forces as well as "other motivational factors". This dissertation deals with the effect of such other motivational factors, inherent to ownership, on the productive efficiency of the firm.

The extent of productive efficiency in a private or public enterprise will depend on its ownership and managerial or organisational structures. The organisational structure of the firm invariably influences not only managerial motivation and incentives, but also the degree of performance monitoring in the management of the firm. Performance incentives and performance monitoring, which will be dealt with below, are the two most important factors in determining the level of productive efficiency within the firm. Such an analysis is consistent with the "property rights" school (Furubotn and Pejovich, 1972:1137-1162), which rejects profit maximisation as the leading behavioural incentive, and instead focuses on the relationship between ownership rights, incentives and economic efficiency with special emphasis on managerial behaviour based on the pursuit of personal interests. Whilst the neoclassical theory focused on the rights of owners, rather than on those of managers, the "property rights" school argued that property rights of owners in the modern managerial firm are more attenuated, rendering less control over managers and employees, and leaving the latter with a greater freedom to pursue personal objectives through discretionary behaviour (Killick and Commander, 1988:1470).

The basis of the conflict between these theories could be found in their different views on the definition of the firm, and specifically its organisational structure. The neoclassical theory of the firm deals with the relatively small owner-managed firm operating in a competitive environment. There is little separation of ownership and control, and owner-managers will set high standards for productive efficiency and will control and monitor the operation of the firm strictly in accordance with their goals of profit-maximisation. The same is true of the concentrated ownership firm in which one person or an organised coalition of persons owns a controlling interest in the firm and exercises direct and strong control over its management (Monsen and Downs, 1972:349). The "property rights" school, on the other hand, bases its theory on the modern managerial firm, defined as a large corporation, usually consisting of more than one firm, with management separated from the shareholders who exercise their control via a board of directors.

Ultimately the issue to be addressed in this dissertation is whether and to what degree the change in ownership, i.e. from public to private or vice versa, of the modern firm will affect allocative and productive efficiency in the economy and thereby the level of social welfare. In the past, economic literature has confused the move towards private ownership (privatisation) with the move towards stronger competition (liberalisation). It is sometimes argued that privatisation will enhance efficiency in the economy only if coupled with the liberalisation of the market. In fact these are two separate issues and should be treated separately. There is also no necessary link between the two. Public enterprises may operate in a competitive market while private enterprises may figure as natural monopolies with extensive monopoly power. Any shift of the public monopoly to the private sector would not per se involve the opening up of that particular market. By definition, the natural monopoly renders very little scope for the improvement of competition. In this dissertation emphasis will be placed on the natural monopoly and the effect of a change in ownership on efficiency. It will be assumed that such an analysis will not be affected by the potential influence of a concomitant change in competition.

CHAPTER 2: CONVENTIONAL VIEW: MARKET FAILURE AND RISE OF THE PUBLIC ENTERPRISE

2.1 MARKET FAILURE - A SYNOPSIS

The neoclassical theory of perfect competition assumes the existence of fully informed, completely mobile consumers and producers striving to maximise their own utility or profit within perfectly competitive markets. It is further assumed that the invisible hand will guide the perfectly competitive market to a position of equilibrium where prices equal marginal social costs. These assumptions are, of course, patently unrealistic. The inability of the market system of any economy to achieve allocative efficiency when left to itself, could be ascribed to those situations, referred to as market failures, in which the invisible hand is prevented from allocating resources efficiently. There will thus be a tendency for the market to produce too many of some goods and an insufficient amount of others.

It is the identification of market failures with allocative inefficiency that provided the main thrust for the formation of public enterprises and other forms of intervention in both developed and developing countries. It was thought that the government would be in a better position effectively to correct the imbalances (i.e. allocative inefficiency) caused by these market failures if it transferred ownership of the enterprise to the public sector. The rationale behind the policy of nationalisation was in fact that government would be in a position to adjust and enforce the key variables aimed at enhancing allocative efficiency in the economy.

The most important manifestations of market failures are the following: (a) inadequate information; (b) inability of the private sector to provide public or collective goods and services; (c) a lack of control over the external effects of production; (d) an inequitable distribution of income and wealth; and (e) the presence of monopolies and other forms of imperfect competition (Falkena, 1981:290-291). In this dissertation the focus will be on the latter market failure. Together, these factors provided the theoretical justification for the proliferation of public enterprises and the extension of the public sector in the period between 1950 and 1980 (Killick and Commander, 1988:1466). In developing countries thousands of public enterprises were created, accounting for over a quarter of gross fixed capital formation in the 1980's (Van de Walle, 1989:603). It will be argued in this dissertation that market failures are indeed failures of the market and not failures of ownership. The factors contributing to market failure do not necessarily result from the form of ownership, i.e. private ownership.

The phenomenon of market failure has been thoroughly discussed and well documented in the literature. The arguments relating thereto will not be repeated here and, for the purposes of this dissertation, the following brief explanation of the most important manifestations of market failures listed above will suffice.

Firstly, adequate information necessary to make rational decisions in the market is either not available or only available at high costs to consumers or producers. This may cause producers to be ignorant of better technologies or other lower cost resources than those used in their plants. Consumers may be unaware of the cheapest available price for the goods and services they buy or of the latent harmful properties thereof, which can only be known at additional costs. The result of inadequate information is that producers operate inside their production possibility curve while consumers find themselves on suboptimal indifference curves. Governments in free societies have generally assumed the responsibility of informing individual citizens by forcing producers through regulation and quality control to disclose certain information and maintain specific standards (Black and Dollery, 1992:10). These measures could be enforced on private producers, and public ownership is certainly not a prerequisite.

Secondly, the existence of public goods in the market has been identified as another factor contributing to the allocative inefficiency in the private sector. The key features of pure public goods are non-excludability and non-rivalry in consumption. It is therefore possible for one person to consume without reducing the amount available for someone else, but impossible to exclude anyone from consumption except at prohibitive cost. Given these characteristics it is clear that public goods are especially vulnerable to the free-rider problem if supplied by the private sector. There simply is no satisfactory demand revelation mechanism. Since all consumers receive the benefits of public goods regardless of their ability or willingness to pay, no individual has the incentive to reveal the intensity of his own preference for the goods in the hope that other individuals will pay for its provision and thereby create the opportunity for free-riding. It follows that the provision of public goods must ultimately be determined on the basis of an appropriate system of collective decision-making and social choice. The provision of pure public goods by the state is generally accepted as inevitable and sound. In practice, however, pure public goods are quite uncommon. Instead the market economy is characterised by the prevalence of mixed or merit goods which have a private good component, but also exhibit public good characteristics. In such cases private provision will have to contend with market failure while public provision will have to deal with the possible implementation of a subsidy and tax policy. The problems relating to merit goods fall outside the ambit of this dissertation. However, it should be remembered that merit goods are often produced by natural monopolies. This will be dealt with more fully later.

Thirdly, externalities are regarded as a major source of market failure and allocative inefficiency, which calls for government intervention. An externality arises whenever an individual's production or consumption decision directly affects the production or consumption of others in a way other than through market prices. It has already been stated that in order to achieve allocative efficiency, marginal social costs must equal marginal social benefits, which in turn requires that marginal private costs equal marginal social costs and marginal private benefits equal marginal social benefits. When these equations are not achieved an external diseconomy exists, of which only two forms will be named here. A producer-consumer external diseconomy occurs when the actions of a producer inflict external costs on consumers for which they are not compensated. A producer-producer external diseconomy, on the other hand, occurs when the action of a producer imposes an external cost on other producers for which they are not compensated (Black and Dollery, 1992:16-17). Private costs often differ from social costs because the resource that is being used or abused is not owned by the same entity inflicting damage on the resource. Externalities are non-excludable and whenever property rights are not well defined, overly costly to enforce or nonexistent, there is no efficient market mechanism by which individuals can internalise the effects of the externality through private trades. The trading of benefits will even be more difficult if the transaction costs are high and if a large number of individuals is involved. The nature of the allocative inefficiency resulting from an external diseconomy is either an over-production of the goods associated therewith, or under-production of other goods.

In the past, governments addressed this failure by assuming an allocative role and using a so-called Pigouvian tax or subsidy aimed at bringing price or marginal social benefit into line with marginal social cost. Interventions of this kind, however, bring about failures of their own, such as imperfect information concerning the size of the externality and the slopes and shapes of the respective supply and demand curves. Moreover, the parties involved have incentives to over- or understate the extent of externalities in order to attract subsidies or avoid taxes (Black and Dollery, 1992:18). The Coase theorem suggested that had property rights been well-defined and enforceable, and transaction costs negligible, market incentives would generate a mutually beneficial exchange of property rights thereby internalising externalities (Coase, 1960). However, the assumptions of well defined property rights and zero transaction costs cannot easily be realised in practice. In essence, externalities constitute a true market failure and a change in ownership per se would not necessarily cause an improvement in allocative efficiency, since both private and public decision-makers have to deal with the same deficiency.

Fourthly, the alleged market failure of an unequal distribution of income and wealth among consumers and producers provided the breeding-ground for important ideological and pragmatic policy considerations behind the creation of public enterprises (Nellis and Kikeri, 1989:660). Firstly, it was believed that public enterprises would generate large profits that could be used for priority investment and redistribution. Secondly, there was a general mistrust of the ability of the private sector to serve the public interest and to disperse generated surpluses throughout the economy. It was believed that only the government could make the "correct" decisions regarding the allocation of scarce resources and that it should therefore hold and lead from the commanding heights of the economy (Nellis and Kikeri, 1989:660). Thirdly, the power vacuum after decolonisation in politically diversified countries caused governments to place a high premium on the control of strategic industries. National security reasons were often put forward as justification for state involvement in heavy industries (Van de Walle, 1989:602). Fourthly, pragmatic considerations gave governments no other option than to rely on public enterprises. This was either because there was no local private sector, or it was too small or insufficiently developed. Furthermore, local private entrepreneurs had limited access to the sources of capital, or were linked to unpopular minorities and foreign powers (Van de Walle, 1989:602). Fifthly, both the ideological and pragmatic reasons coincided with the interests of the state elites, who often used the resources generated by public enterprises to create employment for followers, managerial positions for loyal supporters, and potential rents for their own constituencies (Nellis and Kikeri, 1989:660).

Fifthly, the failure of the market to be competitive is a major cause of allocative inefficiency in the private sector. According to the classical model a perfectly competitive market is a prerequisite for economic efficiency. This entails freedom of entry and exit in the market; the lack of product and price differentiation; and the absence of any individual firm with a large enough market share to influence the level of prices. The competitive conditions enforce an output level at which the price equals marginal costs. The outcome of the perfectly competitive market in theory is that firms do not earn supernormal profits. Furthermore, the Pareto conditions are satisfied for the optimal allocation of factor inputs in the production of goods and for the optimal allocation of such goods among consumers. The cornerstone of this model is the alleged presence of an invisible hand that directs the selfish profit maximising drive of individual firms to promote the interests of society at large.

Another feature of the model is that satisfactory performance depends heavily upon the market structure. In the light thereof, deficiencies in performance have often been attributed to deficiencies in the market structure, and policy remedies used by governments have been aimed at altering such market structures (Devine; 1979:313,314). Since the nineteenth century economists were quick to point out that perfect competition would yield the most efficient use of given resources. It has been argued that the distortions of imperfect competition should be rectified through government intervention in the form of either regulation or nationalisation. Economists, however, came to believe that perfect competition was not only rarely attainable in practice, but has no absolute value and does not guarantee efficiency (Griffith, 1976:156). In the debate on ownership the phenomenon of monopoly is particularly important. It derives its importance from the fact that it involves the concentration of economic power. Monopoly is essentially the control over resources and over the individual preferences of producers and consumers (Brett, 1988:61). Kuznets (1965:195) described the rationale behind the shift to monopoly as *"the increasing use of mechanised power, the greater control over materials, and the greater articulation of the underlying basic knowledge, which made for greater economies of scale, and for an optimum size of industrial plant far larger than that of pre-modern times"*. This has produced an inevitable tendency towards the concentration of economic power and the growth of monopolies in the private sector.

According to Brett (1988:62) the growth of monopolies has led to the formation of a working class with interests totally different from those of capital. Private capital owners were in a position to exercise control, not only over workers and consumers, but also over the government, thereby threatening the democratic foundation of society. The response of the emerging socialist school at the time was to demand the nationalisation of the commanding heights of industry and a shift of control to the people who would exercise their control by way of their vote in the democratic political process.

Two broad categories of monopoly can be distinguished, namely statutory monopoly, e.g. in the form of a large multi-sectoral conglomerate, and natural monopoly. In the first category, artificial entry barriers are used to protect the market shares of incumbent firms from potential newcomers. Generally the statutory monopoly refers to the situation where potential competitors are prevented from entering the market by legal or administrative restrictions imposed by the state or professional bodies. The most common reason for such restrictions is the protection of infant industries.

In the case of the large conglomerate, the entry barrier could also be created by the firm itself. The financial power of such a firm enables it to rely on its own reserves to finance price setting below profit-maximisation level in order to force newcomers out of the market (Black and Dollery, 1992:10). The multi-sectoral conglomerates are characterised by a holding company structure with its subsidiaries spread over different sectors of the economy. Although the subsidiary firms do not necessarily function as monopolies in their respective sectors, they can exhibit some of the characteristics of monopolies (Ramanadham, 1984:103). The most common example is where the inefficiencies of subsidiaries are being protected by inter-enterprise cross-subsidisation so that they manage to compete unfairly with other firms in spite of their inherent weaknesses (Ramanadham, 1984:103).

Before turning to the natural monopoly, it is necessary briefly to refer to the critique of market failure and its identification with allocative inefficiency. Toumanoff (1984: 529-533) criticises the neoclassical model in that it fails to recognise that market failure is to a large extent the result of excessively high transaction costs, and that the concern of neoclassical economists with market failure is a misplaced one being largely due to the inability of their model to account for such costs. According to Toumanoff (1984:531) transaction costs occur as resources are used (a) when market participants attempt to identify and contact one another (identification costs), (b) when contracts are negotiated (negotiation costs), and (c) when the terms of the contracts are verified and enforced (enforcement costs). A theoretical model ignoring these costs must be incomplete in that it leads to unexploited mutually beneficial exchanges in existing markets because the costs of the exchanges exceed the benefits. In this sense Dahlman (1979:141-162) argues that the so-called market failure of externalities can only exist to the extent that transaction costs exceed any benefits from further exchange. Demsetz (1988(a):47-57) supports this view by averring that entry barriers, giving rise to market power, are not real market failures but rather responses to the existence of positive transaction costs. Trademarks, for example, tend to reduce certain transaction costs such as identification costs while raising an entry barrier. In this sense entry barriers may not be a market failure at all, but rather a reaction to the reality of high transaction costs. Toumanoff (1984:533) argues that the incorporation of transaction costs in the theoretical model will effectively render the model consistent with observed behaviour thereby nullifying the implication of inefficiency and market failure.

According to Toumanoff (1984:533) there is a dynamic interaction between transaction costs and alternative institutional environments. He explains that market institutions tend to promote exchanges in which identification of trading partners is particularly difficult, while regulatory institutions tend to promote efficient resource allocation where negotiating costs are especially high. To summarise Toumanoff's argument, it cannot be said that certain institutions cause market failure, but rather that institutions are adopted to accommodate existing transaction costs, which, if duly accounted for in a complete analytical model incorporating all relevant variables, will always certify any behaviour as efficient.

2.2 THE NATURAL MONOPOLY

For the purpose of this dissertation the case of the natural monopoly is particularly important. Natural monopolies are related to industries characterised by such large capital outlays and economies of scale that only one firm can operate effectively in the market. Especially in the case of developing countries with limited markets, the demand for natural-monopoly output is normally not large enough to permit these firms to follow a policy of marginal-cost pricing and break even at the same time. The heavy overhead capital of these firms causes their unit costs to decline rather gradually as production expands (Truu, 1988:256). The position of pioneering firms regarding potential competition is usually entrenched by their superior experience, technological expertise and capital lay-out in the industry concerned.

The natural monopoly is characterised by long-run average cost of production (AC) declining as output increases, as indicated in Figure 1. The marginal cost (MC) curve will lie below the AC curve over the entire output range. The profit maximising producer in a competitive market sets market price equal to marginal costs (i.e. P = MC). The problem with this Pareto-efficient solution is that it results in a loss for the natural monopoly (indicated by $P_cP'fe$ in figure 1), because of the positions of its MC and AC curves (AC > Average Revenue). The monopoly will rather reduce output to the point where its marginal cost equals marginal revenue (at Q_m) and raise price above marginal cost (at P_m). As a result the producer will extract a monopoly rent with a concomitant deadweight loss as consumers' surplus is reduced. In this way resources are being misallocated and a loss is inflicted on society.

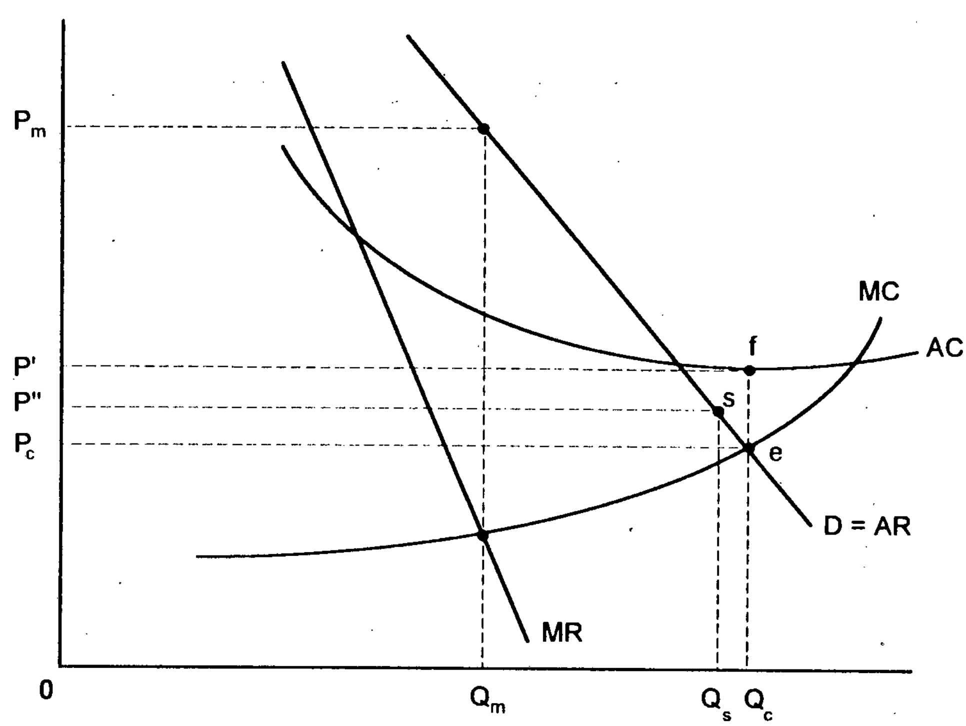

Figure 1: Standard Natural Monopoly Diagram

If the Pareto-efficient level of output is to be produced at marginal cost price, then either (i) it must be produced and supplied by the public sector (nationalisation); or (ii) the private sector will require a subsidy from the government to make it feasible to operate at that level (regulation). In both these cases the government would be responsible for financing the loss from general taxation. Many public monopolies were created or nationalised throughout the world in the belief that even if allowance is made for the distortionary effect of the required tax cum subsidy mix, marginal cost pricing is likely to engender a higher level of allocative efficiency than private monopolies.

The implications of the monopoly for the two-sector model could also be illustrated in Figure 2 by the difference between the slope of the Production Possibility Curve (TT) and the commodity price line (P'P'). In this instance Y is assumed to be the monopolist and X the perfectly competitive industry. The difference in the slopes is accounted for by the fact that the output level of good X is increased at the expense of good Y. The monopoly causes a degree of allocative inefficiency in that at point M, too little of good Y is produced relative to good X. An improvement in allocative efficiency could be brought about by reallocating resources in order to increase the output of good Y and shift the economy towards the competitive equilibrium at point C.

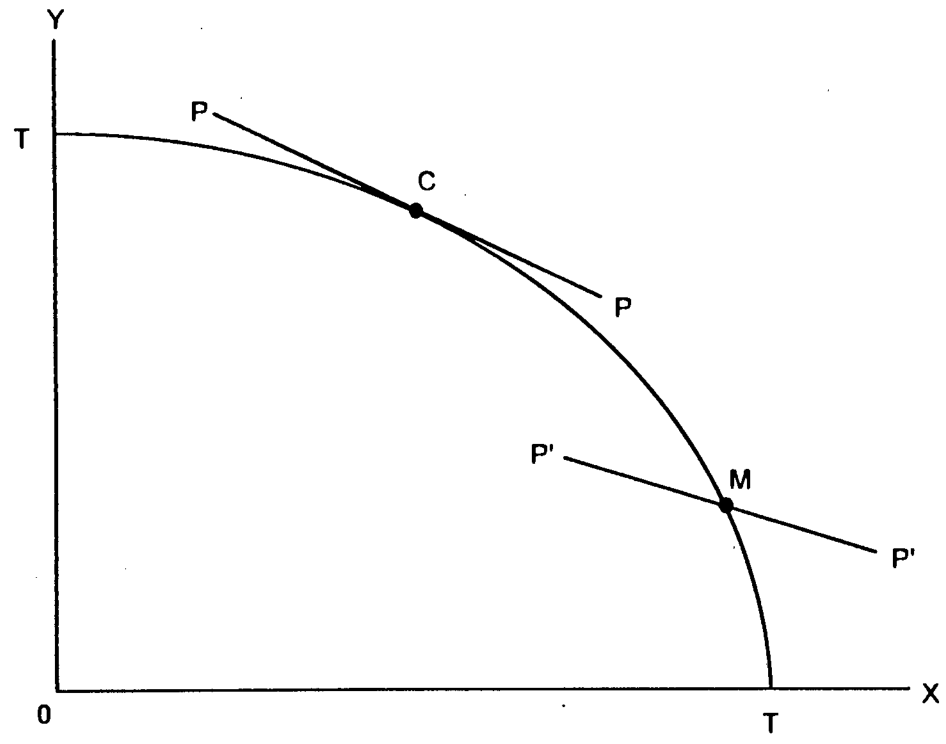

Figure 2

Neoclassical economic theory, according to Nellis and Kikeri (1989:663), associates efficiency outcomes with market structures and specifically with competition levels. It is believed that ownership plays only a secondary role in influencing the level of allocative efficiency (Cook and Kirkpatrick, 1988:20; Hemming and Mansoor, 1988:33; Nellis and Kikeri, 1989:663; Goodman and Loveman, 1991:28). The acceptance of such a theory, however, would be tantamount to surrender to allocative inefficiency in the case of the natural monopoly, where there is little, if any, scope for improved competition within the industry. The characteristics of the natural monopoly make it a suitable candidate for analysing the efficiency effects of a change in ownership. Should the competitive firm or statutory monopoly be used in such an analysis, the danger exists that a change in ownership could alter the market structure in such a way that it would be difficult to isolate the effects of a changed ownership structure on efficiency levels from the possible concomitant efficiency effects brought about either by the improvement of competition or the contraction of the market. If, as in the case of the natural monopoly, very little scope exists for a variation in the market structure, the question to be considered is whether a change in ownership would improve allocative or productive efficiency in the economy, given the market structure in which the firm operates. In this dissertation it will be argued that factors inherent to public and private ownership do have a strong influence on efficiency levels in the economy.

2.3 TRADITIONAL SOLUTIONS IN RESPECT OF THE NATURAL MONOPOLY

Market failure in the form of a lack of competition and the presence of natural monopolies in particular, has played an important role in shaping government policies. Control over natural monopolies was always regarded by governments as extremely important, because it often conferred the owners unchecked economic power over important industries in the economy. Especially in developing countries the core of the strategic public utilities usually consists of natural monopolies that provide essential services without being checked by the discipline of the competitive market. Examples of this type of industry are public utilities providing water, gas, electricity, roads, rail transport and postal services.

In developing countries the satisfaction of basic needs is considered an important function of government. Public utilities deal with bread and butter issues in the economy and public attention is often focused intensely on the price, output and quality produced. Another important factor is the intensifying of the weights attached to the social content of their operations, such as the levels of unemployment, prices and regional disparities (Ramanadham, 1984:110). It is therefore crucial for the government that these natural monopolies should be managed effectively in accordance with the needs of the public at large and aimed at promoting the public interest instead of sectional private interests. The importance of the natural monopoly to society and the fear that the benefits of monopoly pricing could be captured by sectional private interests, paved the way for government to play a strong allocative role.

Traditionally three lines of action have been taken by governments in order to address the market failure of inadequate competition, namely promoting competition, regulating private monopolies and nationalising important industries. Firstly, competition policies, although only feasible in the case of artificial or statutory monopolies, were aimed at promoting counter-balancing forces in the market that could keep individual participants in check. Competition policies have been widely adopted by governments, but with mixed successes. Developed countries implemented policies against restraint of trade, monopolisation and interference with competition (eg formation of mergers) with limited success (Mansfield, 1968:14). In developing countries the creation of a competitive environment involves a long term structural change within the market, which cannot be effected overnight. Thus, existing monopolies could not easily be broken down into smaller units without sacrificing technical efficiency and economies of scale. The line of action taken by government mainly entailed deregulation or the removal of the barriers to entry (eg licences, taxes and standards) as well as the promotion of the small enterprise (Black and Dollery, 1992:11,12). This remedy however, is inadequate when applied to the natural monopoly.

Milton Friedman (1962:28,128,129) rejected the regulation of the private monopoly and suggested a natural shift towards competition brought about by new market opportunities. He held the opinion that the conditions in society may rapidly change so as to introduce new opportunities for competition within a natural monopolistic market and that the public monopoly and regulated private monopoly may be less responsive to and more entrenched against such changes than the unregulated private monopoly which he viewed as the "lesser evil". He did however, admit that if an essential utility or commodity is at stake and the monopoly power is sizable, then even the short-term effects of a private unregulated monopoly may be intolerable and contrary to the public interest (Friedman, 1962:28). The choice should therefore not be made in isolation from the factual circumstances.

The second line of action has been to accept the inevitable prevalence of imperfect competition, and to emphasise the allocative role of the state as regulator in addressing the allocative inefficiency of natural monopolies. If the Pareto-efficient level of output (Q_c in Figure 1) is to be produced at a marginal cost price (P_c in Figure 1), then the government could instruct the private sector to charge the marginal cost price and undertake the responsibility of subsidising the private industry to cover its losses. The subsidy to the private firm (equal to P_c-P′ in Figure 1), will have to be financed by government from general taxation. Since taxes influence relative prices, it will introduce new distortions elsewhere in the economy, which should be weighed up against the inefficiencies that the government intervention were supposed to reduce.

It is therefore difficult to determine the net effect of such a marginal cost pricing policy on allocative efficiency. The theory of the second-best, as generally applied by Lipsey and Lancaster (1956: 11-32), deals with circumstances where price does not reflect marginal cost in all markets, and maintains that efficiency requires the percentage deviation of price from marginal cost to be the same in all industries. The implication is that if imperfect competition exists in one industry only, it might be inefficient in an allocative sense if the first-best Paretian condition, i.e. price equals marginal cost, is implemented in the other competitive industries. As most economies have to deal with some or other restriction, the theory of the second-best will oppose any attempt to realise first-best Paretian conditions on a partial basis (Tisdell, 1972:299-300). With reference to our standard natural monopoly as indicated by Figure 1, the second-best theory will resist regulatory endeavours aimed at achieving a competitive equilibrium at point e. It will instead prefer the regulated monopoly to operate at a point such as s, with output at Q_s and price at P′′, while reducing both the subsidy to the monopoly and the degree of tax distortion elsewhere in the economy. In this way it is suggested that the economy could be fine-tuned so that price could exceed marginal cost by the same proportion throughout the economy in order to achieve a second-best solution.

The process of regulation involves mechanisms by which governments could gain control over private monopolies. In the absence of competition, systems of licensing and the supervision by regulatory agencies have been used by governments to protect the public interest in the case of essential utilities supplied by the private sector. These agencies determined the size of the subsidies and specifically guarded against possible abuse of monopoly power by private interests in respect of pricing, output, quality of service and the provision of uneconomical but socially essential services and facilities (Moore, 1992:121). With regard to pricing, formulas based on the retail price index and adapted to take account of all the related factors have been used as a market substitute (Moore, 1992:121). With regard to output and quality, the licences set clear performance targets that should be met as well as specific requirements relating to the maintainability of uneconomical, yet indispensable services (Moore, 1992:121).

The regulation of the private monopoly aimed at enforcing an allocatively efficient price-output mix, proved to be a complex if not impossible task. The efficiency of this system depends heavily on the quality of the information revealed by the regulated firm. The problem is that the information on which the regulation is based, is provided by the very victim of the regulatory process, namely the regulated private firm. Its management will be tempted to misrepresent the facts in order to protect their monopoly rent and bargain more favourable conditions. According to Yarrow (1989:55) regulatory agencies not only have to deal with monopoly in the supply of the product or service, but also with monopoly in the supply of information. Regulation based on the assumption of perfect information, offers a straightforward remedy to allocative inefficiency.

It is, however, characteristic of monopolies to accord considerable power to managers in the control of information flows to regulators and shareholders alike (Yarrow, 1989:55). A further problem facing regulating agencies is that past performance of the monopoly, as a basis for regulatory decision-making, could be manipulated by private managers by inflating their costs or biasing investment programmes so as to induce more favourable allowances regarding prices and output levels (Yarrow, 1989:55). If management, on the other hand, chooses sunk investment expenditure to reduce costs as well as prices, it runs the risk that the government may decide to enforce these low prices without allowing the firm to recover its sunk costs (Vickers and Yarrow, 1991:114). Information on consumer preferences and the firm's cost conditions will be difficult to obtain in a monopolised market (Yarrow, 1989:60). One of the most important advantages of improved competition is the concomitant extension of information available to regulators resulting in more effective policies aimed at enforcing the optimal output level of the firm and curbing allocative inefficiency.

An important development in the field of regulation has been to make the process of application for and granting of licences subject to competition. Competitive tendering for the right to serve the market at the lowest price to the consumer for a fixed or agreed quality of service has been suggested in this regard (Veljanovski, 1989:49). It involves the auction of monopoly rights and is based upon competition at the licensing stage to eliminate monopoly prices and practices. A strong rivalry between the applicants ensures that monopoly rents are passed on to the consumers in the form of lower prices and higher output. Demsetz (1968:55-65) argued that if there was a large number of bidders and very little collusion among them, the winning bid could offer a price that is very close to per-unit production costs. The system relies on the self-interest of the applicants to define the terms of the franchise and reveal the information necessary to choose the best applicant (Veljanovski, 1989:49). It also reduces the role of a regulatory agency as well as the possibility of additional distortions. One drawback of this system, especially in respect of natural monopolies, is that the franchise has to be awarded for a considerable time period because of the large capital investment that has to be made. In the case of re-tendering, the incumbent firm will be in a position to offer more favourable terms than newcomers, because of the existence of sunk costs (Veljanovski, 1989:50). The existing firm can therefore entrench its stronghold on the industry and regain its monopoly power over time. This would largely frustrate the spirit and aim of the franchise-model.

The above-mentioned problem areas have frustrated governments in their attempts swiftly to correct the imbalances caused by the lack of competition. However, the intricacies surrounding the regulation of private monopolies fall outside the ambit of this dissertation and the above explanation will suffice. The general conclusion to be drawn is that regulation was inefficient due to the fact that government lacks effective control over private enterprises.

The third line of action ventured by governments was to gain full control over the monopoly by taking over its ownership and to manage it in the public interest. Public ownership was a way by which governments endeavoured to gain direct de facto control over important industries. Public monopolies have been created or private monopolies nationalised for a variety of reasons. In developing countries the reasons were either pragmatic, in the sense that the private sector did not have adequate finances for the required capital outlay, or ideological, in the sense that public utilities provided the government with a strategic measure of control over the economy (Van de Walle, 1989:602). In the more developed economies the belief has been that even if allowance is made for the distortionary effect of financing losses, the policy of marginal cost pricing in public monopolies is likely to engender a higher level of allocative efficiency than in the case of regulated private monopolies, as discussed earlier.

With reference to Figure 3, where sector Y is the natural monopoly and sector X perfectly competitive, it is shown how the position of the unregulated monopoly (at point M) changes after nationalisation and the application of marginal cost pricing. The shift to P indicates that, even though a greater quantity of Y is supplied at a lower cost, the additional cost of taxation causes point P to lie below the production possibility curve (TT). Whether the change in ownership will in fact mean an improvement in the level of social welfare, will depend on whether the benefit of the rise in output outweighs the additional cost of taxation.

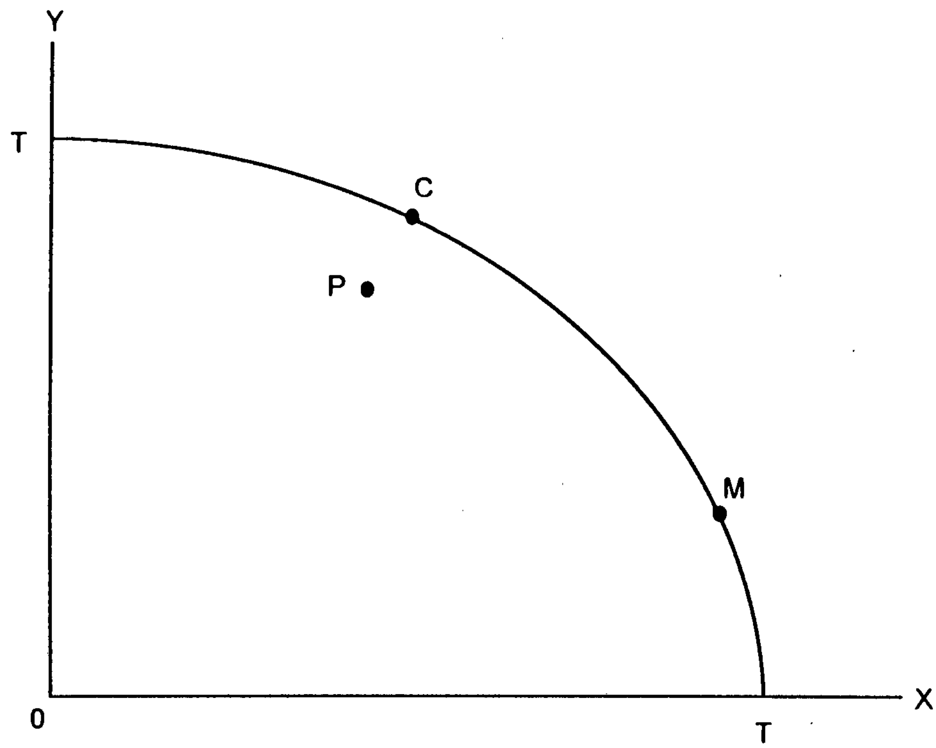

Figure 3

It was believed that by nationalising private enterprises and by acting as owner in stead of regulator, the government could more easily ensure that the desired output is produced at the required price. The problems associated with ineffective regulation persuaded governments to strengthen their allocative control by taking over the responsibility of ownership and management. This policy shift, which was very popular in western economies during the post-war period, opened the door for the replacement of market failure with public failure, and it is to this issue that we now turn.

CHAPTER 3: PUBLIC FAILURE AND FALL OF THE PUBLIC ENTERPRISE: OWNERSHIP, CONTROL AND ALLOCATIVE INEFFICIENCY

In this chapter, we will explain how an important feature of public ownership, namely the separation of ownership by citizens and control by politicians and bureaucrats, contributed to its own downfall by creating the breeding ground for public failures. This lack of control by owners has given rise to the use of the public enterprise by politicians and bureaucrats as a political instrument, and has resulted in an oversupply of relatively unpopular public goods and, thus, allocative inefficiency. Therefore, instead of redressing the problem of insufficient output under the private monopoly scenario, an overkill has taken place towards the opposite extreme of allocative inefficiency.

3.1 SEPARATION OF OWNERSHIP AND CONTROL IN THE PUBLIC SECTOR

The phenomenon of the separation of ownership and control is present in both the public and private sectors of the modern economy. This feature provides the essential background for a comparative analysis of the publicly and privately owned modern firm. The improvement of allocative efficiency is an important step in the maximisation of social welfare. As discussed above, market failures provided the logical basis for public ownership. In the absence of an effective market mechanism, the public sector is left to its own devices to aim its decision-making at improved allocative efficiency. Because social welfare is at stake, the society at large bears the risk of the outcome of such policy decisions. It therefore follows that a mechanism should be available whereby the members of society have a say in the allocative decision-making process. Under perfect circumstances, the political process of representative democracy provides such a mechanism.

The public firm in a representative democracy is "owned" by the country's citizens and "managed" on their behalf by politicians as their chosen representatives. Practical considerations require politicians to delegate their managing power to their appointees, i.e. bureaucrats, who undertake the day to day management of the public firm. Each public firm is characterised by a hierarchy of power and a network of rank where officials report to bosses, and these bosses in turn receive instructions from their superiors. Top officials are accountable to politicians who form the government or the central administration of the country. On their part, governing politicians are responsible to the broad community, as the true owners of public goods, for ensuring allocative efficiency in the public sector. The country's citizens are indeed the "shareholders" of the public firm and use the ballot system to appoint and replace politicians as its directors to ensure that allocative policies within the public sector are in line with the public interest. Governing politicians not only derive their power from the people, but also act as their representatives in the same way directors of managerial firms are appointed by and represent the shareholders. Under public ownership, therefore, the firm is run by public managers (bureaucrats) on behalf public directors (politicians) who exercise control in their capacity as the agents of the owners, i.e. the people.

The people can use their right to vote via the political process to put pressure on politicians to direct public firms in such a way that the maximisation of social welfare is ensured. The management of public firms could therefore be controlled, albeit indirectly, by the citizenry, in that they have the collective means to persuade politicians to make the correct decisions regarding output and price. Voters could also pressure politicians either to replace inefficient managers and bureaucrats, or to be replaced themselves. In practice, however, public failure has prevented voters, as the real owners of public firms, from effectively controlling or supervising the allocative decision-making of politicians and public managers, thus resulting in a relative welfare loss.

At the root of public failure lies the failure of the political process in representative democracies to provide a reliable and effective mechanism by which political behaviour could be monitored. The political process is handicapped by a complex monitoring hierarchy, involving a two-tier delegation process; first from the members of society (as principals) to politicians; and second from politicians to public managers (Yarrow, 1989:53). Regarding society's control over politicians, the weakness lies with the poor interaction between politicians and voters, which takes place through a highly imperfect political market place that is not especially designed for monitoring specific allocative decisions. As a monitoring device, the political system in representative democracies has proved to be defective in more than one respect. Firstly, the members of society could only exercise their property rights through a collective political process which do not recognise any one individual's ownership of these firms (Veljanovski, 1989:36). The ownership share of an individual member of society in a specific public firm is also too small to produce a large enough incentive for monitoring allocative decision-making. Such dispersal of ownership renders ineffective any control by owners over managerial behaviour. Secondly, voters are ignorant of much of what politicians stand for, since they do not have sufficient incentives to acquire this information (Black and Dollery, 1992:21). Thirdly, politicians are elected on the basis of a complex package of policies and therefore do not have to please the majority on each separate policy issue. It may be possible for a politician to draw the vote of a citizen who disagrees with 49 percent of his policies. Furthermore, a voter who disagrees totally with the economic or managerial policies of a political candidate, may still vote for such candidate, because of his/her views on another important issue such as defence or public health. This paves the way for implicit logrolling favouring special interest legislation as well as for arbitrary political intervention aimed .at gaining sectional support (Black and Dollery, 1992:21). Fourthly, politicians have large incentives to conceal information that may be detrimental to their political wellbeing. Bureaucrats may also team up with politicians to publicise only information which is politically acceptable and thereby secure their own future careers. On the other hand, they may decide that merely to articulate certain problem areas and to propose possible solutions, will draw enough political acclaim, without assuming responsibility of implementing it (Wolf, 1979:115). Fifthly, because of practical and financial reasons, elections cannot be held annually. Society is forced to bear with inefficient politicians for a period of four or five years before they could replace them via the ballot box.

With regard to society's control over public managers or bureaucrats, it is evident that ordinary citizens have little access to information on allocative decision-making within the public firm other than those publicised by politicians and senior officials in the manner discussed above. Voters have to approach politicians with their queries, who not only have a tendency to protect their appointees and conceal the bad news, but also have difficulties in obtaining the correct information from public managers. This is so because it is usually very difficult to measure the output and quality of public or semi-public goods in the absence of market structures (Wolf, 1979:113-114). It is for example very difficult to compare the quality of education, welfare programmes and environmental regulation with that of previous years. Wolf (1979:114) submits that monitoring quality requires precise, representative and regularised feedback which is hard to realise for non-market output.

It can therefore be concluded that the members of society, as owners of public firms, have lost effective control over the management thereof. The severance of the control function from the ownership function, left open the door for politicians and managers to run public firms so as to further their personal objectives, rather than those of the broader society.

3.2 THE PUBLIC ENTERPRISE AS POLITICAL INSTRUMENT

The separation of ownership and control creates the freedom for politicians to use public firms as political instruments, aimed at furthering their personal political aspirations at the expense of allocative efficiency. They regard the public firm as a useful political instrument by which they could control important economic variables, protect politically sensitive industries, serve powerful interest groups and so doing promote their personal political careers. This politicisation of the public sector has contributed to the oversupply of relatively unpopular public goods by over-sized public firms thus rendering the public sector inefficient in the allocative sense. Although the creation of public firms improved the ability of the state to influence the allocative decision-making in the economy, it also brought commercial decision-making within the complexity of the political arena. This created the possibility of a public failure, i.e. public over-supply, especially in cases where the political system is such that the pursuit of personal political agendas of politicians is not constrained and checked by the countervailing powers of owners (Vickers and Yarrow, 1991:113-114).

The politicisation of the public sector involves the departure from conventional economic decision-making in favour of political decision-making. Politicians have the tendency to ignore conventional economic rules relating to allocative efficiency, for example the rule that marginal cost and price should be equated, if they consider it politically convenient to do so (Van de Walle, 1989:602-603). Instead they apply the vague criterion of political expediency to allocative decision-making. In this way they would be expected to support those policies exhibiting clear vote-maximising potential and strongly resist those that may have unpopular side-effects. Furthermore politicians would be inclined to make unrealistic pre-election promises and then find it difficult to fulfil the exaggerated expectations that they created.

The problem is that politicians operate in a political market place where there aim is to accumulate support. It follows that, if politicians are allowed to exert strong influence on the economic market place via the public sector, the allocative decision-making process will be politicised. Depending on the degree of politicisation, public firms will be pressured by politicians to produce more goods at lower prices, for it is usually the most popular action to take. In this way a culture of allocative inefficiency is created.

Vote-maximising behaviour of politicians in a quest to satisfy personal political objectives forms the backbone of the politicisation process and contributes greatly to public failure and specifically to the oversupply of public goods. In representative democracies, vote-maximising behaviour entails activities of politicians aimed at securing and retaining political office. Politicians first and foremost strive to maximise their personal political popularity or that of the party they belong to. It might be argued that politicians would gain enough political patronage by merely serving the interests of society at large, for it is the members of society who will eventually decide whether or not to re-elect incumbent politicians. However, in the previous chapter it was indicated that because of the separation of ownership and control in the public sector, members of society or owners of public firms are not in a position effectively to control or evaluate the performance of politicians. It will therefore be in the interest of politicians to promote popular and conspicuous policies while concealing or avoiding the unpopular ones. Should politicians be allowed to intervene in the allocative decision-making process of public firms, such intervention will necessarily be governed by the underlying objectives of vote-maximisation. Such behaviour translates into public failure, because of the divergence between the personal political objectives of politicians and the social objectives of society as a whole.

The first question to be answered is why politicians would aim their vote-maximising behaviour at the public sector rather than the private sector. At the outset it must be borne in mind that historically public enterprises have been very popular institutions among voters, simply because it had pioneered many developing economies into essential fields where the private sector was absent. The problem was that the private firms in many less developed countries simply could not afford the initial capital and running costs of producing certain basic public goods. The provision of basic public services and goods to the broad community often entailed the lowering of prices below average costs in order to raise output to socially acceptable levels. Public firms were first established in developing countries mainly because of the scarcity of private capital to finance the large capital expenses required to produce certain basic utilities and essential goods. This was especially the case with natural monopolies where initial capital outlays were large and a large output was necessary to ensure profitability. In the words of Labra (1980:40) the public firm was *"seeking to provide employment and income to stimulate demand and, through it, public and private investment in a politically stable and progressive atmosphere based on attention to the needs of* *the majority of citizens"*. The popularity of the public firm, based on socially acceptable objectives, opened up the opportunity for politicians to involve themselves in managerial decisions-making with the support of the broad community.

Not only was the public firm a popular "voter friendly" institution, but it also proved to be a versatile instrument by which politicians could directly influence a variety of economic variables. The public enterprise offered a strategic political and social avenue for the speedy reactivation of the economy through the direct stimulus of employment, an increase in the overall supply of goods in the economy, and an improvement of income distribution. Many countries strongly relied on the public enterprise as the backbone of their economic policies and the instrument by which to influence critical elements like employment, provision of foodstuffs and foreign exchange (Labra, 1980:39).

It must be borne in mind that public managers were essentially government officials obliged to obey the instructions of government, irrespective of whether they were politically inspired or economically unsound. With regard to private firms, politicians do have the power to intervene in its managerial decision-making process by enforcing "politically correct" policies via the legislative process, but with less ease and at greater costs than in the case of public enterprises (Vickers and Yarrow, 1991:114). The legislative process, however, involves a slow, cumbrous and public process, to the extent that the whole purpose of the intervention could be undermined. To sum up, the fact that public enterprises were popular and versatile institutions that could be controlled and manipulated by self-interested politicians, created a fertile breeding ground for vote-maximising behaviour and public failure.

Four types of vote-maximising behaviour will now be discussed: firstly the artificial political manipulation of popular economic indicators; secondly, satisfying the demands of strong lobbying groups; thirdly, expanding the size of public firms; and fourthly, creating exaggerated expectations among voters.

Firstly, politicians consider it in the interest of their own political careers to ensure that popular economic indicators reflect a favourable picture in order to create the impression that the economy as a whole is in good shape. Ordinary citizens lack the economic expertise and the specialised information to make an educated judgment on how the economy is performing at any point in time. As a result, they often rely on popular, understandable economic indicators such as inflation, unemployment, wage increases and the availability of basic goods in order to asses the well-being of society and the success of economic policies at a given time. By artificially influencing these popular variables, politicians can "window dress" the economy in order to "buy" political support, even though it might be at the expense of long-run allocative efficiency. The easiest and quickest way for politicians to influence particular economic variables, is via the public sector where they have easier access and control to adjust prices, wages, investment and output. Such political intervention in economic decision-making pursuant to hidden vote-maximising agendas, can be expected to be arbitrary in nature.

Politicians usually defend such interference by claiming that it serves the public interest by correcting existing market failures. More often, however, such government intervention is based on political expediency and is usually arbitrary from an economic perspective. The reason for this is that political intervention is used for a variety of political aims. These aims include buying electoral support in pre-election times, pleasing certain high profile interest groups, meeting the expectations of loyalists, satisfying the claims and answering the criticisms of the opposition. More specifically, political agendas entail different elements such as redistribution to favoured interest groups, high employment levels in politically sensitive sectors and assistance to underprivileged groups or regions (Vickers and Yarrow, 1991:113). These goals are usually achieved by expanding supply and restricting prices of public goods, resulting in allocative inefficiency in the form of an oversupply of public goods. Interventionist policies are very rarely embodied in a detailed long-term economic and socio-political plan. They are rather designed in arbitrary fashion to achieve short-sighted covert political goals which do not necessarily enhance the public interest. Political popularity is a very sensitive variable and subject to a wide variety of pressure groups in society. In order to please everyone, governments will often persuade public firm management to pursue a variety of policy objectives. The nature of the government's intervention and the emphasis placed on each individual objective will vary with the ebb and flow of the political tides. Although individual policies improve allocative efficiency in that it could bring about a more equitable distribution of income, the arbitrary nature of government intervention in public enterprises severely hampers the systematic pursuit of allocative efficiency.

Secondly, politicians focus on meeting the demands of public employees and consumers of public goods, both being strong political lobbying groups. The political power of public employees is due to the strong solidarity among the employees of public firms who all work for the same employer, i.e. the state, with seemingly unlimited resources. The consumers of public goods usually make up a large percentage of the total voting power in the country. Especially in developing countries where basic goods are provided by the public sector, nearly all citizens are consumers of these goods and regard them as basic necessities. Politicians will therefore go a long way in trying to meet their politically sensitive demands and accommodate their needs. In this way, the public sector offers a speedy mechanism to politicians by which they can satisfy and give relief to important political pressure groups during crucial political periods. The timing of such relief policies will also follow the rules of political expediency. However, such political intervention is often distortive in an economic sense, due to the discrepancy between political and economic time frames. Political time frames which are governed by political opportunism, are usually incompatible with the longer time cycles that business needs (Moore, 1992:117). Disregard by politicians of ignoring commercially viable time frames and the enterprise's need to remain competitive, can inflict permanent damage to an industry if they try to fulfil election promises by artificially creating more jobs for unemployed voters or by manipulating prices to favour dissatisfied consumers (Moore, 1992:117). Intervention of this kind is aimed at gaining short-term political patronage during critical stages in the careers of incumbent politicians, for example when important bills are to be approved by Parliament or during the run-up to elections. An example would be the tendency of the government to lower the price of petrol during the pre-election campaign, knowing that it is a popular short term policy, even though it could have a long term detrimental effect on fiscal policy and allocative efficiency. Another example would be the political timing of adjustments to civil servants' salaries without taking into consideration productivity changes.

In the third place the degree of control exercised by politicians over important variables in the economy depends on the size of the public sector under their control. A relatively large public sector renders more direct control to politicians over the economy as a whole. Bearing in mind that politicians are inclined to accumulate economic power and control, they would want to promote the growth of the public sector by increasing the number of public employees. The expansion of public employment could be used by politicians as a vote-maximising instrument. This policy could, for instance, be pursued under the pretext of a popular policy measure such as curbing unemployment. A larger civil employment also increases the number of potential voters from which political support could be bought through direct measures such as an increase in wages or fringe benefits. In similar vein, politicians will be very cautious to streamline over-staffed public enterprises, because of the potential loss of popularity they could suffer from a public outcry against forced redundancies. However, the artificial expansion of public employment for political reasons will result in allocative inefficiency, in the sense of an over-supply of public goods by over-sized public firms.

In the fourth place, politicians are inclined to create unrealistic expectations among consumers and public employees. Consumers have come to expect public enterprises to maintain high levels of output at "fair" (low) prices and also to continue providing unprofitable goods and services, while workers have come to believe that wages should be paid regardless of productivity and that they have the right to jobs regardless of efficiency (Pryke, 1981:262-265). Such unrealistic expectations often originate from politicians themselves, who are inclined to make many promises during election campaigns without taking into account that they will have to live up to them when they are elected. An example of this is the false expectations created by the political parties before the first democratic elections in South Africa to the effect that houses will be provided for all the homeless if they were to win. High expectations intensify demand and put pressure on the public sector to raise its output beyond efficient levels.

Many examples of politically induced allocative inefficiency have been recorded. Only a few will be discussed here to illustrate how political intervention could lead to the oversupply of public goods. In 1973 when the British Gas Corporation bowed to political pressure and artificially maintained low domestic prices in order to absorb the OPEC oil shocks, this policy endangered the competitive position of electricity utilities, which burned coal (Moore, 1992:117). From this flowed excess capacity in the electricity industry and surplus production in the coal industry, together with shortages in gas production, resulting in the refusal of important industrial business opportunities favouring domestic consumers. Consumers, who eventually switched to gas, were hard hit by the inevitable rise in gas prices to catch up with the market (Moore, 1992:117).

Grassini (1981:70-82) studied the political constraints in Italian public enterprises during the 1970's and identified four political goals which politicians expected their public managers to pursue: creating new jobs and avoiding dismissals; improving working conditions; employment for political patronage; and financing political campaigns. Managerial performance is often judged on these political considerations instead of commercial viability. He remarks that in this way many public enterprises continued to make losses for years without efficiency being questioned, as long as it could be attributed to the cost of adhering to social objectives. Another example, according to Moore (1992:117), is that politicians may overrule commercial judgments by building a new factory in a politically sensitive area where unemployment is rife, or in the same vein refusing to close uneconomical plants. In this way, by placing greater emphasis on the concern for jobs than on efficiency, even greater job losses may occur in the long run.

Richard Pryke (1981:262-265) furthermore maintained that while government policy during the 1960's was that public enterprises should operate at minimum costs, earn reasonable profits and behave commercially, nationalised industries in the 1970's were expected by their governments to pursue a variety of vague, contradictory and diverse objectives in order to please different political pressure groups. In this way they were required simultaneously to expand their staff to please trade unions, hold prices down to satisfy consumers and maximise profits to appease the Treasury. Public enterprises were being seen as instruments of economic and social policy and not as commercially disciplined undertakings (Pryke, 1981:262-265). This conflict in objectives causes confusion in management which is not conducive to allocative efficiency.

In the sixties the UK government did try to establish some consistency in its conduct of political intervention by setting financial targets and laying down economic guidelines. The Prices and Incomes Board (PIB) were convened to ensure that the guidelines are met. But the PIB was dismantled in 1971 and the financial targets rendered meaningless by mounting inflation and heavy subsidies (Baumol, 1980:227). The ad hoc intervention in the form of subsidisation caused an oversupply of public goods and had a damaging effect on the allocative efficiency in the public sector. This is emphasised by the fact that the granting of a permanent subsidy to British Rail was followed by a dramatic reduction in productivity growth together with a vigorous recruitment drive which led to an increase of 8000 employees between the end of 1973 and March 1975 (Baumol, 1980:227). According to Nellis and Kikeri (1989:663), governments in developing countries cannot resist the temptation to interfere, no matter how good their stated intentions are. Even though they have committed themselves to non-interference with stated policy, governments tend to resort to public enterprises in times of crisis in order to accomplish instant economic and socio-political results. When the government finds itself in a desperate situation it will be tempted to "bribe" the electorate by increasing the output of public goods and thereby providing short-term relief to hard-hit communities as well as short-term political survival for the incumbent government.

The conclusion to be arrived at is that politicians are vote-maximisers by nature and tend to aim their vote-maximising behaviour at public enterprises in a continuing effort to gain economic control and accumulate political support. It seems as if such political intervention in the commercial decision-making of the public enterprise is an inherent characteristic of public ownership. This vote-maximising intervention is usually focused on influencing popular economic indicators, on satisfying the needs of public employees and consumers of public goods, on expanding the size of public employment and on trying to meet the unrealistic expectations of voters. In doing this, however, the long term interest of the economy and the public in general are being sacrificed for the short term personal interests of politicians. The maximisation of social welfare is also replaced by the maximisation of the personal political wellbeing as the hidden agenda for the public enterprise. Although politicians will conceal such vote-maximising objectives under the mask of some popular socio-economic aim, political behaviour of this kind usually amounts to arbitrary intervention on an ad hoc basis according to vague, contradictory policies. The result is an oversupply of public goods and allocative inefficiency.

Public failure, i.e. the oversupply of public goods, can now be illustrated by Figure 4, depicting the Production Possibility Curve (TT) with product Y as the monopoly good. Point C is the competitive output mix where allocative efficiency is achieved. Point M is the monopoly position reflecting a lower output and higher price of Y than is allocatively efficient. Public ownership of the natural monopoly is aimed at redressing this misallocation by setting price equal to marginal cost and increasing the output of Y up to the competitive position C. The presence of public failure caused by vote-maximising behaviour of politicians, however, results in an over-supply of Y, moving the economy to an inefficient position such as P. Given the tax-induced distortions accompanying the subsidisation of public firms, the equilibrium will lie inside the TT curve, e.g. at point P′. In order to make a comparison between private and public ownership, the allocative inefficiency brought about by market failure (at point M) should be compared with that of the public failure (at point P′). Naturally the answer will depend on the degree of deviation from the competitive position.

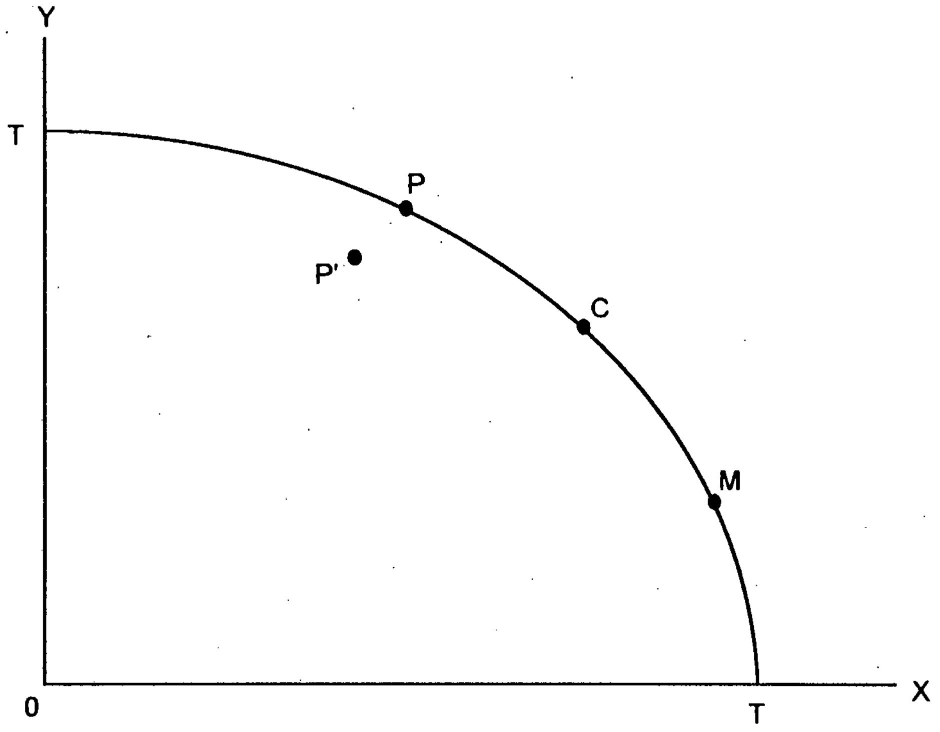

Figure 4

3.3 Summary

Insufficient democratic control over politicians renders them the freedom to use the public enterprise as a political, vote-maximising instrument in their personal interest. In this way politicians intervene in the allocative decision-making process on the basis of political expediency instead of economic viability. Such political behaviour leads to public failure in the form of an oversupply of public goods and therefore allocative inefficiency.

CHAPTER 4: PRIVATE RECOVERY AND RISE OF THE MODERN MANAGERIAL FIRM: OWNERSHIP, CONTROL AND ALLOCATIVE EFFICIENCY

In this chapter it will be shown that even though the separation of ownership (shareholders) and control (professional managers) is also prevalent in the modern managerial private firm, its effect is to move the private modern monopoly closer to the ideal position of allocative efficiency. It is ironic that the same factor which led to the fall of the public enterprise, also assisted the rise of the private managerial firm.

4.1 SEPARATION OF OWNERSHIP AND CONTROL IN THE MANAGERIAL FIRM

In this analysis the managerial firm of Monsen and Downs (1972:348-351) will be taken as a model for the modern corporation or managerial firm. Managerial firms are large corporations with such widely dispersed ownership, that no individual or even a small group of shareholders could gain sufficient votes to exercise effective control over the firm. It is, however, possible that in a managerial firm only a few percent of votes are required for de facto control (Beed, 1972:139). The former is the true managerial firm, while the latter could be treated as a type of hybrid owner-managed firm where a group of owners, though only a minority, exercises control over managers. The problem with the hybrid owner-managed firm is that control is precarious and tends to fluctuate with the frequent formation of new coalitions. Such a tendency renders control unsustainable and ineffective over the long term. In this way, the hybrid owner-managed firm cannot be readily distinguished from the true managerial firm.

The central hypothesis of Monsen and Downs (1972:351-356) is that ownership is dispersed among many shareholders and separated from management, and that management itself consists of a bureaucratic hierarchy. The fact that economies of scale do not exist in the provision of capital, supports the idea of a large managerial firm with a large number of relatively small shareholders (Demsetz, 1988(b):113). In the managerial firm the shareholders appoint a board of directors which has the ultimate power over management. Such delegation of power includes the capacity to set policy and to replace inefficient managers. Each firm is operated by a hierarchy of managers (separate from the shareholders) who do not own substantial shares in the firm. It could therefore be said that a shift has taken place from control by ownership to control by contract, in the sense that professional managers are contracted by owners to run the firm on their behalf (Murray, 1987). The reason for the delegation of power by the owners to management via the board of directors, is essentially pragmatic. If all owners were first to consult with each other in order to decide on managerial issues, the economies of scale will be neutralised by high negotiating costs. This problem intensifies as the firm diversifies its activities into different fields of specialisation.

Economists entertain different views as to the reasons for the great size of the managerial firm. One view is that it could be necessitated by the inevitable prevalence of economies of scale in large scale production. The firm must be large enough to carry the large capital commitments of modern technology (Galbraith, 1972:128). Another view is that mere size enables the firm to exercise monopoly power in the market. The large size of the managerial firm enables it to earn profits above the levels usually associated with a perfectly competitive industry. However, according to Galbraith (1972:128-129), the main contributing factor to the large size of the managerial firm is not economies of scale or monopoly, but control. Size empowers management to exercise control over supply, demand, the provision of capital and minimisation of risk. The bigger the firm, the more control over these factors is bestowed upon management. Therefore there is no upper limit to its desirable size. It also gives them the autonomy from invasions by the state, trade unions and also by shareholders.

The complexity of technical and managerial decisions in the operation of these large techno-structures, acts as protection against outside interference (Galbraith, 1972:131). Neither the suppliers of capital, nor the shareholders have the expert knowledge to intervene in managerial decision-making. The managing of a modern corporation has become a highly specialised profession that calls for technical expertise. Efficiency is indeed promoted if owners renounce their de facto control in favour of a professional management (Demsetz, 1988(b):114). Furthermore, many shareholders prefer being relieved from the duty of day to day decision-making and having the opportunity to concentrate on their responsibilities as owner. The power of decision-making is traded for the comfort of limited liability. Owners also tend to specialise in investment rather than control.

By the provision of an internal source of capital, derived from its own profits, the modern corporation has isolated itself from external control or interference (Galbraith, 1972:132). Financial institutions and shareholders have very little control over how retained earnings are invested or otherwise dealt with. The development of the managerial firm conferred unchecked power on management and separated it further from the scrutinising control of capital providers. In the words of Galbraith (1972:132), *"few other developments can have more fundamentally altered the character of capitalism"*.

Although shareholders retain the capacity to decide whether or not to sell their shares, they are essentially lenders of capital instead of owners in the true sense of the word (Demsetz, 1988(b):114). Such separation of ownership and control holds important implications for the debate on ownership and efficiency. The goals and motives of professional managers as well as the monitoring of their performance should be analyzed in order to arrive at conclusions regarding the relative efficiencies of private and public firms. Similar to the traditional theory of the firm, both owners and managers are primarily motivated by their self-interest, but with the difference that they have conflicting interests and different ways of pursuing them. The assumption of profit maximisation, as applied in the neoclassical theory, would only be valid if firms were operated by the very owners who share in its profits. Since managers usually do not share directly in the firm's profits, their different self-interests lead them to behave differently regarding the firm's profits. This has a positive effect on allocative efficiency, which will now be explained.

4.2 PRIVATE OWNERSHIP AND THE MOVE TO ALLOCATIVE EFFICIENCY

The biggest concern of the private monopoly has been its tendency to inflate prices and contract output in order to earn monopoly rents. New forces in modern economies are coming to the fore causing existing private monopolies and oligopolies to behave more like competitive firms and reducing the allocative inefficiencies due to monopolistic pricing policies. These forces, which are rooted in the separation of ownership and control, include (1) the emergence of sales maximisation as a managerial objective, (2) the increase in importance of the public image and social responsibility of the firm, and (3) new thinking on the competition between large managerial firms.

The aggregate effect on the economy, as illustrated in Figure 5 where Y is the monopoly industry, is that the managerial monopoly increases its supply and lowers its price below that of the pure monopoly, thereby moving nearer to the competitive position, e.g. from M to M'. It is to the examination of the above forces which we will now turn.

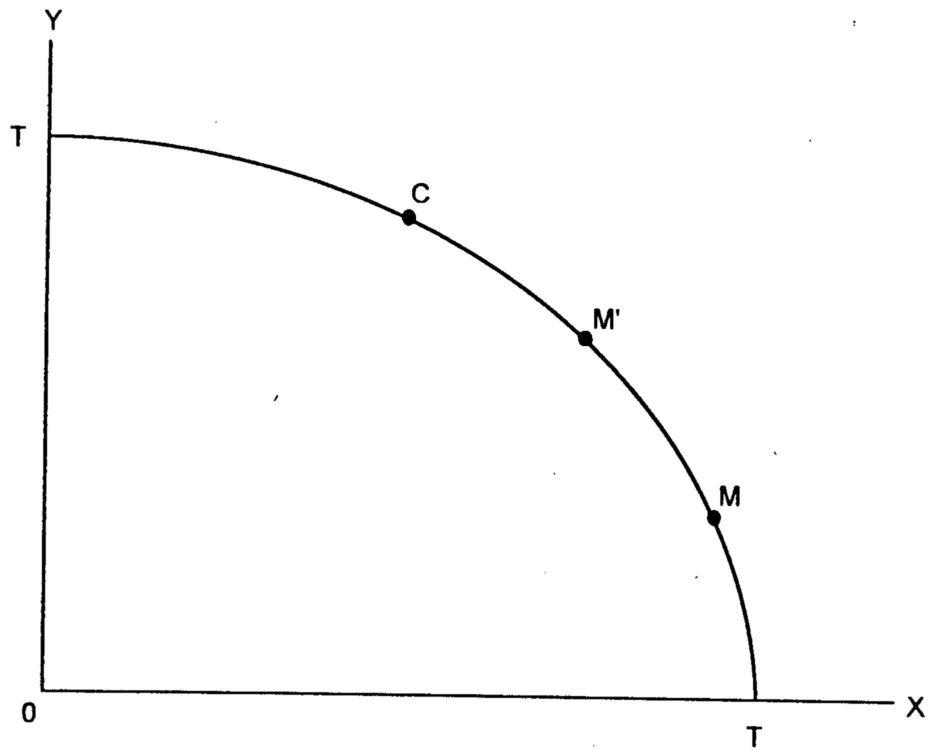

Figure 5

4.2.1 Sales maximisation

One of the cornerstones of the traditional theory of the firm is the goal of profit maximisation. While shareholders may reasonably be assumed to be profit-maximisers, it has been argued that management of the modern managerial firm may have different objectives. The separation of ownership and control means that managers have greater freedom to pursue their personal objectives with little risk of being exposed. It also suggests that managers (and not owners) are really in control of modern enterprises.

Baumol (1967) contended that sales maximisation is an important goal of management, because it serves basic motives of management such as social standing, self-esteem and security. The social standing and power of managers are directly related to the number of employees or subordinates having to report to them as well as the mere size of the firm. Managers are also tempted to expand staff and gross assets, because the marginal product and therefore salary of a manager often depend on the size of the resources affected by his decisions (Mayer, 1960:189-193). The pursuit of these objectives are more important to the manager than to achieve excessive profits. These objectives motivate managements of modern firms (even monopolies) to expand output and reduce prices -- a tendency which is in the opposite direction of that usually associated with monopolies and which, in effect, represents a movement towards the competitive position.

Thorstein Veblen (1924) believed that the separation of ownership and control in the managerial firm contributed to allocative efficiency. He preferred control to be in the hands of professional managers who are interested in output growth rather than monopolists who lean towards the contraction of output and inflation of prices. In this way, the notion of sales maximisation is a positive move towards the improvement of allocative efficiency.

4.2.2 Public image and social responsibility

A recent development in the style of management which has important effects on allocative efficiency, is the emphasis placed on the public image and social responsibility of the firm (Bibb and Bendix, 1991:43-59). Milton Friedman (1962:133-135) regarded the idea of corporate officials pursuing social responsibility, rather than serving the interests of their owners, as counter-productive and undermining the very foundations of the free society. He argued that entrepreneurs should stick to what they do best, namely maximising profits on behalf of their stockholders, in which case the element of free competition will guide the industry like an invisible hand to serve the public interest. They have neither the political legitimacy nor the public expertise to perform the public functions of taxation, expenditure and control -- tasks belonging to elected politicians of social democracies. He is of opinion that businessmen who sacrifice profits in order to make a social contribution, actually take capital (dividends) out of the hands of shareholders and prevent them from deciding for themselves how surplus funds should be invested.

Friedman may have disregarded the modern trend of monopolisation and the separation of ownership and control in respect of the modern corporation. The technical expertise of management and the growing complexity of their accountability, have caused shareholders to renounce their power of control in favour of management. Shareholders also prefer to diversify their investments to reduce risks and are content to be specialised owner-investors. They will only invest in those firms which they believe have a management competent and efficient enough to manage their capital on their behalf. To use Friedman's line of argument, specialised owner-investors should have the opportunity to do what they do best, namely seeking the best available investment opportunities. In the same way specialised managers should be entrusted with what they do best, namely managing the capital invested in a specific firm.

The balance of power however, is in the process of shifting towards the broad community. In developing countries especially, the Marxist and socialist critique against capitalism has established a suspicion that the large corporation would abuse the extensive power at its disposal in favour of sectional interests and to the detriment of the community at large. The perception was that self-interested allocative decision-making by management (checked only to a lesser degree by owners and competitors) would bring about substantial harm to society.

The worldwide movement to greater democracy contributed vastly to the empowerment of the majority against the "oppressive forces" in society. The suspicion towards large business as well as the democratisation of society brought about new checks on the allocative decision-making process. The belief that large corporations have great power and that shareholders do not control their corporations, contributed to such suspicion (Demsetz,1988(b):257-258). Nowadays, the large corporation is being seen as a social institution with a social responsibility to society apart from its responsibility to its owners (Bibb and Bendix, 1991:54). The large corporation has come to reflect a very prominent public image which is duly scrutinised by politicians, consumers and the media.

Politicians use their legislative power to align managerial behaviour and perceived public interest. Consumers use the instrument of consumer boycotts to express their preferences. The media has also become a powerful instrument in uncovering malpractice and informing the public of managerial decisions. The media is indeed in a position to build or to break down the sensitive public image of the large corporation. Not only does it act as the watchdog of society, but it also articulates the social responsibility of management and the general public interest. The media furthermore embodies a strong persuasive power aimed at influencing the decision-making of managers who are very concerned about the public image of their firm as reflected by the media.

Friedman's fear that businessmen are in no position to determine their social responsibility (other than maximising profits) is made less justified by these new developments. The prime objective of entrepreneurs has changed from maximum profits, based on narrow self-interest, to optimum long term profit based on enlightened self-interest (Tusenius, 1985). The firm will still be maximising its own utility, but its utility is now extended to include living up to a positive public image. Social responsibility activities, contributing to the public image of the firm, may exert a positive influence on the firm's transactions with third parties, thus adding to the demand for its product or service and boosting its profit (Black, 1995:6-7). In this way the pursuit of a better public image is related to the notion of profit-maximisation. Management will have to reconcile the internal forces (owners and workers) with the external forces (politicians, consumers and media) in order to arrive at an equilibrium providing for satisfactory profits, wages and social contribution. Society has become an increasingly complex environment for efficient decision-making, but management too has become more sophisticated and specialised. A sophisticated management will be able to process the claims from different pressure groups in order to come up with a satisfactory compromise for the managerial firm and the broad community.

Public demand for a higher level of social responsibility on the part of large corporations, has grown in recent times. Especially in a highly politicised society like South Africa with a history of colonisation and apartheid, the sentiments of the majority strongly favour bigger involvement of business in rectifying historic imbalances (Bibb and Bendix, 1991:49-51). South Africa's first democratic elections in 1994 endorsed the policy of affirmative action aimed at eradicating poverty and uplifting backward communities. The strong reliance on this policy by the ANC during election campaigns, raised the expectations of its supporters of the relief to be brought about by the implementation of such policies. Big businesses offered their co-operation regarding this policy and now face the task of satisfying the intense popular demand for large-scale socio-economic relief. The social responsibility of managerial firms in the democratic South Africa has increased greatly. Large corporations find it in their long term interest rather to cut their monopoly rents, expand output and invest in social upliftment, than to be labelled as an oppressive capitalist concern. Investment in social responsibility action may enhance the legitimacy of the firm and create a more stable environment which is conducive to economic efficiency in general.

It is of course not the task of management to formulate social goals, but it will have to follow the policies as articulated by the democratically elected government.

Bibb and Bendix (1991:48) maintain that *"the neat conceptual distinction between private economic goals and public, social goals -- the former to be pursued by businessmen, the latter by elected leaders -- simply does not hold up in reality"*. Examples of such social involvement in South Africa include investment in training, education, municipal services and housing. In this way, the monopolistic behaviour of large firms is reversed and allocative efficiency is improved.

4.2.3 Managerial firms and competition

Although it is not the purpose of this dissertation to discuss ways to improve the level of competition in the market, it can be mentioned that new thinking on the competition in the market of the modern monopoly and managerial firm has come to the fore. When it became evident that the full conditions of the perfect competition model were not practically realisable, Clarke suggested an alternative model of workable competition, selected from those that are practically possible (Devine, 1979:318). The essential ingredient of this form of competition (which is aimed at oligopolistic markets) is rivalry, either actual or potential, among profit-maximising suppliers who vie among themselves for the customer's patronage (Devine, 1979:318). It is, however, based on the unrealistic assumption that the long run average cost curves of new firms are substantially the same as those of the established firms (Stigler, 1942:2-3).

This model, suggested in 1940, was the forerunner to Baumol's model of contestable markets (Baumol, 1982:1-7). The contestability model proposes that, since the presence of many competing firms in the same market is not a necessary condition for achieving allocative efficiency, the existence of only a small number of firms in a particular market does not, in itself, imply monopoly power and allocative inefficiency (Cook and Kirkpatrick, 1988:20). Even though a market may be monopolistic or oligopolistic, certain conditions may come into play which make it contestable and thus allocatively more efficient. These conditions are, firstly, that decreasing returns to scale should have set in and, secondly, that entry into the market should be free and unrestricted and exit from it costless (Truu, 1988: 263). If these conditions are met, any monopoly price in excess of average cost would create profitable opportunities for new entrants and expose the monopolist to the hit-and-run strategies of potential contenders who are instantly ready to collect the available monopoly rent before being forced out again (Cook and Kirkpatrick, 1988:20).

The policy implication is that the government should endeavour to make markets more contestable by removing entry barriers and thereby preparing the ground for allocatively efficient pricing by the monopoly or oligopoly (Cook and Kirkpatrick, 1988:20). It is however, not adequate to remove entry barriers while the existence of "sunk" costs (costs that cannot be eliminated when production stops) rules out the possibility of a free and costless exit by the firm finding it unprofitable to remain within the market (Cook and Kirkpatrick, 1988:20). The condition of free entry is difficult to realise in the wake of monopolies which dominate the industry by their size and scope of activities and which would not be intimidated by the remote possibility of hit-and-run contenders (Veljanovski, 1989:28).

Even though these conditions will not easily be met in practice, this model draws the attention to the fact that potential competition can serve as a check on the uncompetitive market and enforce an allocative outcome which is a step towards the classic Pareto-optimal position.

In the case of industries with only a few large producers, increased competition could contribute to increased levels of output and lower prices, and thereby rectify allocative inefficiency. It is the view of Stigler (1942) that competition among large enterprises is stimulated by relaxing the restriction on mergers and by giving them a clear mandate to grow through the use of fair means. In the USA mergers enabled managements to build more diversified and better integrated enterprises. Such enterprises are capable of reaching all parts of the market and are particularly adaptable to market shifts, changes in technology and variations of economic climate (Mansfield, 1968:115). They are also favourably positioned to support technological research and development.

Competition within an industry where production is concentrated among only a few large firms tends to be vigorous for two reasons (Mansfield, 1968:17). Firstly, because the competitors are easily identifiable, the participants keep close track of the market position and behaviour of their rivals. Secondly, the growth in investment on research and development by large firms has intensified the competitiveness of the concentrated industries and has increased the quality of competition among large firms which is far superior to that among small firms (Mansfield, 1968:17). The innovative investment of large firms in the long term offers a wider range of choice to the consumer -- something the small firm could not at all afford (Mansfield, 1968:18).

4.3 SUMMARY

In conclusion it can be said that the separation of ownership and control in the modern managerial firm has helped to restrict the rise in prices and decline in output previously related to large firms operating in uncompetitive markets. The monopolisation of the private sector and its effect on price and output have been the strongest critique against private ownership and specifically its performance in respect of allocative efficiency. It has been submitted here that the modern managerial firm is behaving more and more as if operating in a competitive market, especially due to the managerial objective of sales-maximisation and the increasing importance of the public image of the firm. The question which we will now consider is to what extent productive efficiency is sacrificed by the rise of the managerial firm and the improvement in allocative efficiency.

CHAPTER 5: OWNERSHIP, CONTROL AND PRODUCTIVE EFFICIENCY

5.1 BACKGROUND AND EMPIRICAL EVIDENCE

One of the main weaknesses of the public enterprise is its poor track record regarding productive efficiency. The general mistrust of the public enterprise during the 1970's and the increasing popularity of privatisation policies ensued from this public failure. But how serious is this deficiency? And in what way is it caused by public ownership? Furthermore, would a change of ownership be a sufficient remedy? This chapter deals with the factors inherent to ownership (public or private), that have an influence on the productive efficiency of the firm.

Adam Smith (1937) believed that publicly owned land was 25% less productive than privately owned land. He gave the following reason for his statement: *"The attention of the sovereign can be at best a very general and vague consideration of what is likely to contribute to the better cultivation of the greater part of his dominions. The attention of the landlord is a particular and minute consideration of what is most likely the most advantageous application of every inch of ground upon his estate".*

Empirical evidence confirms Smith's opinion by indicating clearly the gains in productive efficiency experienced by state-owned monopolies or oligopolies after privatisation (Moore, 1992:119). The UK's experience of the 1980's shows how the productivity per employee of British Airways and British Gas had risen by 20%. Labour disruptions at Associated British Ports declined rapidly after privatisation. Furthermore, the overall call-failure rate at British Telecom dropped from one in twenty five to one in two hundred and the traditionally long waiting list to have a telephone installed virtually disappeared. In respect of public telephones, statistics indicate that while only 75% were operational before privatisation in 1980, 96% were in working condition in 1992. In respect of developing countries, Ramanadham (1984:119) arrives at the conclusion that the financial performance of public enterprises is, in general, poor.* Nellis and Kikeri (1989:664) state that considerable empirical evidence indicates that higher rates of return on total assets employed in the private sector of developing countries could be found than those prevailing in roughly comparable undertakings in the public sector.

The factors to be analyzed here are the role of trade unions (5.2), the motivation and incentives of managers (i.e. fear of bankruptcy and take-overs, managerial needs and goals) (5.3), the performance monitoring by owners and the capital market (5.4), rent-seeking (5.5), innovation (5.6) and managerial competency (5.7). Traditionally these factors formed the ideological basis of the arguments favouring private and denouncing public ownership. Too little emphasis, however, had been put on the ownership structure within the firm.

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* This view is substantiated by research done by the International Workshop on Financial Profitability and Losses in Public Enterprises, ICPE, Ljubljana, 1981:23].

In this chapter, therefore, the traditional arguments will be confined to a comparison of public firms on the one hand and owner-managed firms on the other hand. The traditional conclusion to be derived from such an analysis, is that private ownership, where owners exercise direct control over management, is conducive to optimum productive efficiency. In respect of the modern managerial firm, however, the model of Monsen and Downs allows for the separation of ownership and control. These characteristics led to the attenuation of owners' capacity to monitor and control the firm's performance, resulting in a deterioration of productive efficiency, as managers are given freedom to pursue their personal goals. This development may eventually force owners to revise their goal of maximum profits and to adopt the second best goal of satisfactory profits. When this happens the foundation for long term productive inefficiency is laid. In respect of its bureaucratic nature and monitoring capacity, the managerial firm may be found to behave similarly to the public firm, exhibiting the same drawbacks regarding productive efficiency. It will be argued however, that the private managerial firm is still to be preferred to the public enterprise insofar as productive efficiency is concerned.

5.2 ROLE OF TRADE UNIONS

The underlying idea of this section is that the management of the public enterprise, in comparison with its private counterpart, is more exposed and vulnerable to the mounting pressure exercised by increasingly powerful trade unions. Such pressure is aimed at furthering the interest of employees in the name of social democracy, regardless of the detrimental effects on productive efficiency and the implications for the public interest. It is submitted that the rise in power of trade unions vis-à-vis public enterprises is an important cause of productive inefficiency in the public sector.

It should be kept in mind that many trade unions were established in pursuit of the Marxist concept of a worker's party government that would protect worker's interests against capitalist powers (Murray, 1987). The rise in trade unionism provided a way of countering the power of governments and especially the public monopolies that were believed to be abusing their power at the expense of their employees. In some countries trade unions gained enough support to switch the balance of political and economic power in their favour. Although trade unions also operate widely in the private sector, it will be shown that they found the public sector a much more favourable battle field and one on which they were met with less resistance by management. In other words, the bargaining power of the public sector trade union is generally stronger than that of its counterpart in the private sector (Killick and Commander, 1988:1472). This phenomenon could be explained with reference to political, economic and ideological considerations.

Firstly, the public sector trade union tends to have considerable political power. It is submitted that trade unions find themselves in a stronger bargaining position vis-à-vis the public as opposed to the private enterprise. This notion arises from the fact that unions not only form economic, but also political pressure groups against the government and the central budget. It finds itself in a position to exert influence as a pressure group representing not only employees, but also enfranchised citizens. In the private sector disagreements are resolved internally through negotiations between management and union leaders and within the financial limitations as prescribed by the rules of commercial viability. Public sector trade unions, on the other hand, have the tendency to transform the matters in dispute into political issues with popular appeal. Unions from different industries in the public sector consolidate to form a monopoly power block against the state as their common employer. This is facilitated by the fact that all public employees share the same objective namely to bargain for higher wages and better working conditions for their members.

The organisation structure provided by trade unions is also very susceptible to political abuse by union leaders. Their captive membership is easy to mobilise, while their common grievances and aims act as a bonding agent uniting the workers in a strong political lobbying group against the government, which is likely to be singled out as the scapegoat when their claims are not met. The matters in dispute are then extended by politically active union leaders to include issues of ideology. These issues fall outside their mandate as worker representatives and cause confusion in the negotiation process with management. The government may find it difficult to resist the political pressure in addition to the financial restraints it has to cope with. In the end the additional bargaining power enables trade unions to negotiate wage increases beyond productivity levels.

Secondly, financial considerations strengthen the bargaining power of trade unions. The fact that the central budget is always available as a safety net for public enterprises makes it difficult and politically sensitive for management to deny workers' claims on financial considerations alone. According to Roy (1980:46) a public enterprise does not serve capitalistic interests, but is answerable primarily to government and therefore cannot easily check workers' demands. While the government assumes the role of rescuer of last resort, there will be no ceiling to the claims of trade unions. Public ownership tends to raise expectations of workers who come to believe that they have a right to jobs and that wages should be paid regardless of productivity considerations (Pryke, 1981:265). Public employees regard their claims and expectations as reasonable in the light of their perception that the government cannot go bankrupt and will always provide the necessary funds when the public enterprise is in trouble. Any denial of what the unions may regard as a reasonable demand, will be perceived by the workers as a politically prejudiced decision by the government on the allocation of available resources. In the case of the private firm, labour and management are opposing interests, and even though the process of collective bargaining is prone to conflict, some degree of equilibrium is eventually reached (Roy, 1980:46). The difference is that the rules of commercial viability act as an objective criterion governing the outcome of collective bargaining in the private sector.

Thirdly, the claims of trade unions are backed by strong historic ideological considerations. The source of the high expectations within public trade unions can be found in the Marxist notion that the workers are the real owners of the public enterprise and that they should not be alienated from the product of their labour. This ideology was strongly advocated by trade unionists all over the world. It gave momentum to the workers' struggle for self-determination or for a larger say in management and the allocation of resources. Employees of public enterprises thus obtained an elevated status. Not only did they view themselves as ordinary citizens in whose favour the public enterprise should be run and who have the ability to influence management and government decisions by casting their votes during elections, but they also regarded themselves as the real owners of the enterprise who should have a direct say in allocative decision-making. The opinion was held that the public enterprise should in the first place be managed in the interest of the workers and only in the second place in the interest of the general public. This resulted in trade unions pressuring the government to raise wages even if it meant subsidising productive inefficiency from government coffers and subsequent tax increases. According to Murray (1987), reforming the labour market was seen by "socialists" as one of the prime goals of public ownership. More specifically these goals entailed improved working conditions, industrial democracy, equal opportunities, increased flexibility of working time and human-centred technology. However, these goals were pursued without due consideration of financial and commercial realities and productivity.

The rise of trade unionism resulted in the reduction of productive efficiency in the public sector. Trade unions succeeded in bargaining wage settlements and other employee perquisites above productivity levels, while at the same time preventing concomitant redundancies of public employees and rises in the price of public goods. This accounts for the fact that public enterprises are characterised by unstable labour relations resulting in many lost man-hours and x-inefficiency due to strike actions and labour disputes respectively. The result is public sector production below the Production Possibility Curve, indicating a loss to society in the form of productive inefficiency.

Likewise, if governments comply with wage demands and maintain too high levels of employment, productive inefficiency may result. During the 1970's in the UK, public trade unions became increasingly powerful and militant. During 1971, 1972 and 1974 in the UK the nationalised section, one of the most strongly unionised in the economy, which accounted for only 7% of all employment, had to endure no less than 40%-50% of all days lost in strike actions (Pryke, 1980:224). After it was nationalised, British Rail (one of the six largest employers in Britain) was under continued pressure from trade unions to maintain high employment levels and to maximise the size of its staff, even when economic viability prescribed necessary redundancies (Wolf, 1979:120). The result was high employment per unit of service which is enough incentive for on-the-job slackness and inertia by managers and workers alike (Wolf, 1979:120). This development provided an important rationale for the inception of the policy of privatisation in the UK. When the Conservative Party came to power in 1979 it gave momentum to this process and gave public enterprises an ultimatum to raise domestic prices in order to cover average costs, and insisted that wages should not exceed productivity (Pryke, 1981:265).

As would be expected in the light of the above, the policy of privatisation was vehemently opposed by public sector trade unions. Union leaders argued that such a policy will adversely affect employees if, subsequent to privatisation, the firm goes bankrupt, government subsidies are discontinued, or there are forced lay-offs by the new private owner (Van de Walle, 1989:606). The true concern of trade unions, however, was more likely the fact that privatisation would remove politics as a bargaining tool, alter the industrial relations climate in favour of management, and generally upset a longstanding modus vivendi with the government (Curwen, 1986:167). The resistance of public trade unions to privatisation and to the commercialisation of struggling public enterprises, must be seen in the light of the Marxist view of the private ownership as a bearer of forces that discipline labour and promote capital accumulation (Murray, 1987). The ideology was that capitalists are trying to control labour, speed up production and press down wages in order to generate surpluses for capital accumulation. Trade unions wanted to reverse this drive by demanding extended public ownership aimed at goals that conflict with capital accumulation namely higher wages, better working conditions, more human-centred jobs, equality on the factory floor and greater industrial democracy (Murray, 1987). Privatisation would mean that the bargaining power of labour unions would be stripped from its political element and reduced to bare economics. They were reluctant firstly to sacrifice their political power base and secondly to support a policy that means redundancies and lower wages even when it is aimed at improving productive efficiency.

Union leaders would argue that it is socially undesirable to improve efficiency at a time of general unemployment. It is their view that inefficient employment, although substantially the same as disguised unemployment, is still to be preferred to the demoralisation and humiliation of open unemployment. Seen in perspective however, it is clear that in discontinuing unproductive and unprofitable activities, cross-subsidisation can be eliminated and prices reduced to cover costs (Pryke, 1981:256). This can be the spark to generate compensating output and employment elsewhere in the economy. On the other hand, the maintenance of unproductive employment in public enterprises would inevitably lead to fewer jobs elsewhere.

The basic premise of the market system is that different participants compete on an equal footing, with the bargaining power of each acting as a check and balance on the power of others. It is submitted that public ownership, in light of the considerations mentioned, creates the breeding ground for excessive trade union bargaining power resulting in prolonged productive inefficiency. Selective privatisation could therefore contribute towards levelling the playing fields by reducing excessive trade union power and restoring the balance between the wellbeing of the workers and the interests of the public at large.

5.3 MOTIVATION AND INCENTIVES

A further factor favouring private ownership as opposed to public ownership is the nature of managerial motivation and incentives. In the words of Yarrow (1989:53), *"ownership matters because the transfer of a firm from the public sector to the private sector (or vice versa) will lead to a change in the incentive structures facing its decision-makers".* Furubotn and Pejovich (1972:1139) also believed that once human motivations are known, a better understanding of the organisation's use of resources becomes possible. The fear of bankruptcy and take-overs in the traditional owner-managerial firm presented private management with real incentives to be productive, while their personal needs and goals provided the necessary motivation.

5.3.1 Fear of bankruptcy

The fear of bankruptcy serves as a strong motivation and incentive for superior managerial performance in the private sector vis-à-vis the public sector, the reason being that public managers and employees are not subjected to this fear, due to their reliance on the continuous support provided by the state budget. History has shown that the government will intervene to help ailing public enterprises, either to save political face or to pursue broad policy goals like stability and growth. Politicians will rather increase subsidies than having to explain to the electorate why certain public goods cannot be supplied any more and why public employees have to lose their jobs. These are politically more sensitive issues than the issue of increasing subsidies. This characteristic of public firms results in a lack of a struggle for survival, and is an ideal breeding-ground for productive inefficiency in the public sector.

Privatisation introduces the discipline of hard budgets and commercial capital markets as opposed to the "soft budget constraint" so often enjoyed by public firms (Nellis and Kikeri, 1989:663). Efficiency improves as long as there is an urgency to maximise profits or at least to keep the firm in business. A complacent management risks the chance of going bankrupt in which case the resources released would be employed by those who have the urgency to utilise it more efficiently (Nellis and Kikeri, 1989:663). It could be argued that the lack of competition could render the incentive of the fear of bankruptcy less effective. It is submitted, however, that under the same market circumstances, private firms, with or without competition, will be more productively efficient than public firms as a result of this incentive.

The prevalence of a soft budget constraint in the public sector and the fact that government will not allow public firms to go bankrupt, contribute to removing an important productivity incentive from the minds of public managers and employees. This has led to the bureaucratic red tape and slackness that are so often encountered in public firms or services. The same has occurred in the modern private sector with the appearance of the large conglomerate firm. The holding company provides a safety net for struggling subsidiaries aimed at protecting the public image of the group at large. Successful subsidiaries are used by the holding firm to cross-subsidise loss-making firms within the group. This trend seriously reduces the threat of bankruptcy as an important efficiency incentive to the management of the subsidiary.

The question is whether this cause of productive inefficiency would be more prominent in a public firm than in a large private conglomerate. The lack of a fear of bankruptcy in the private sector is made good by the existence of another incentive namely the fear that the holding company may sell the subsidiary if it continues to burden the group. In an environment of strong competition for investment capital, it is inconceivable that a large conglomerate would persist in subsidising ailing subsidiaries on a permanent basis. It must be conceded that this threat will only be realised in the last resort if nothing could reasonably be done to reverse the fortunes of the subsidiary. However, it remains a real threat and will be a contributing factor in keeping managers on their toes and so promoting productive efficiency.

5.3.2 Fear of take-overs

According to Hanke (1986:16) public and private enterprises could be distinguished by "*...the fact that public assets are not owned since they cannot effectively be transferred. This lack of transferability means that decisions taken by public bureaucrats and employees do not readily translate into changes in the market price of the firm's assets.*"

Citizens dissatisfied with the way in which a public firm is managed, cannot sell their fraction of "ownership" to others. This is an important difference between public and private ownership that has a bearing on productive efficiency. In the private sector shares and assets become tradable and a market for managers develops where managers could easily be replaced if they do not live up to the expectations of owners (Nellis and Kikeri, 1989:663). Disillusioned private shareholders have the option of voting with their feet by selling their shares to outsiders.

The ability to sell shares engenders the possibility of a take-over. This possibility poses a real threat to managers in the private sector. If an investor sells his shares, he will be perceived to be expressing his disapproval of the firm's managerial performance. Share prices will fall in direct proportion to the number of shares sold, thereby inviting new investors with new ideas about managerial efficiency to take over the firm (Furubotn and Pejovich, 1972:1130). The rationale behind take-overs is vested in the confidence of capitalist outsiders in the capacity of the firm to outperform current levels by reducing existing organisational slack and promoting productive efficiency. Share price partly reflects the potential capital gain inherent in the corporate stock; and the lower the share price, relative to the potential under more efficient management, the greater the danger for a take-over by those who believe that management can be more efficient. In the event of a take-over, managers and employees would be at risk of losing their jobs as part of a rationalisation programme by the new owners, who would want to stamp their authority on the firm by employing a new motivated team of managers and employees aimed at improving productive efficiency. The threat of take-overs is therefore a strong incentive for managerial performance.

Shareholders can exercise this capacity to sell their shares independently of other shareholders and can exercise it without dissolving the firm (Demsetz, 1988(b):114). Furthermore, negotiating costs in trading shares are reduced by the fact that shareholders are protected by their limited liability. This quality removes the duty of potential owners fully to inform themselves of the performance and liabilities of the firm and of the assets of other shareholders before deciding to buy or sell shares. These attributes facilitate the effectiveness of this incentive mechanism and promote the development of an organised market for securities. Demsetz (1988(b): 114) maintains that the smoother this market operates, the more important the incentive of the fear of take-overs will be.

The continuous pressure of potential take-overs may, however have a detrimental effect on allocative efficiency in that it could move managers to concentrate on short-term profits in order to bolster share prices and thereby neglect long term considerations. However, as Grossman and Hart (1980:42-64) point out, the relationship between the capital market and productive efficiency can be complicated, due to factors such as transaction costs, free-rider problems and lack of sufficient information by shareholders. The higher the cost of (a) gathering inside information of the firm, (b) actually trading the shares, and (c) preventing other shareholders from following suit without having to share the costs, the less imminent will be the risk of take-overs.

However, the question can be raised whether the threat of privatisation could not serve as a similar incentive for enhanced productive efficiency in the public sector. The management of a struggling public firm could be warned by government that it will privatise the firm if improved productive efficiency is not achieved within a certain period of time. Incumbent public managers will dread a "privatisation" take-over to the same degree as will private managers when confronted with an ordinary take-over. It should be borne in mind however, that the privatisation of a public firm could only be carried out after its endorsement by a slow and cumbrous political process. Such a policy decision is always politically sensitive and usually provokes wide controversy among managers, employees and the public who are in effect the real "owners" of the public good. The threat of privatisation is not as imminent and therefore does not contain the same incentive value as a private take-over.

A case has been made out that private management's fear of a possible take-over acts as a real incentive for the maximisation of productive efficiency. In the case of a take-over, managers fear that new owners would try to achieve higher productive efficiency by pressuring and disciplining existing managers or by replacing incumbents who cannot perform according to new standards. In respect of the diffused ownership managerial firm, however, this performance incentive has been severely attenuated. In the managerial firm owners find themselves separated from management and therefore from the operation of the firm (as fully discussed earlier). As a result, managers are inclined to screen unfavourable information from shareholders and the board of directors. The high costs of gathering information prevents the establishment of a well-informed ownership. Due to the large number of owners, they will also be slow to react on news of inefficiency in the management of the firm. At least while managers of the large managerial firms are in a position to conceal "detrimental information" from the shareholders, they can put to rest any fear of a possible take-over. Without information on poor managerial performance, existing shareholders will not be in a position to reconsider their ownership. Potential buyers will also not be aware of the value of unexploited opportunities in the firm. In this way an important incentive to productive efficiency within the managerial firm is being sacrificed. To illustrate how much value managers can destroy before they face a serious threat from shareholders, Jensen (1989:64) contends that between 1977 and 1988, takeovers and buyouts in the USA averaged 50% above the market price of the shares. These takeovers not only create new value but also unlock the value destroyed by management through productive inefficiency. The problem with the managerial firm is therefore that managers find themselves in a very secure position vis-à-vis outsiders. They can destroy much value and underutilise the potential of the firm for a long period before having to face the threat of a possible takeover.

It is, however, possible for the managerial firm to behave like the classic concentrated ownership firm in respect of this incentive. The threat of take-overs is not only applicable to a change of ownership of majority shareholding. A "take-over" could also be effected by a group of minority shareholders. If several minority shareholders are dissatisfied with the existing managerial policies and performance, but do not want to terminate their ownership, they can try to gain effective control temporarily to oust the incumbent management or to force through new policy (Demsetz, 1988(b):131). They can do this by concentrating shareholding in the hands of a group of shareholders with similar views on the management of the firm. Proxy battles and share-purchases as well as the formation of voting blocks can be used as mechanisms to translate ownership into de facto control and decisive action (Demsetz, 1988(b):131). These mechanisms increase the risk for managers to be replaced if they do not cooperate with the shareholders who have effective control. Such behaviour will have a positive bearing on productive efficiency.

In the public sector there are very limited possibilities for citizens (as the true owners) to take quick steps to alter policies within the firm. Citizens will have to follow the complex and sometimes hazardous political avenue, as discussed in the previous chapter. Lobbying power could be used to persuade politicians to act quickly in serious cases. However, the threat of a "take-over" will only be real at the time of a general election when the position of the governing party could be challenged. With regard to this incentive of productive efficiency, it would therefore seem as if the private managerial firm will be preferable to the public firm.

5.3.3 Personal needs and goals of managers

In the analysis of productive efficiency, it is not only the objectives of managers and employees as representatives of the firm that matter, but also their own personal needs and goals. One must not disregard the fact that managers and employees are in the first place utility maximising human beings who will be inclined to put their personal interest before that of the firm, except where they could be persuaded that it is in their own personal interest to pursue the interests of the firm. We will now consider the managerial needs and goals in the private, public and managerial firms respectively.

5.3.3.1 The private firm

In the owner-managed firm, the self-interest of the manager usually coincides with the traditional motive of profit maximisation. High productive efficiency will mean lower costs to produce a given output and higher profits in the pockets of the owner-manager. The profit motive is always a strong incentive for private owner-managers to pursue productive efficiency. This motive inspires managers to eliminate slack and unproductiveness, because they personally share in the fruits thereof, i.e. increased dividends and value of their shareholding. The motive of profit maximisation has indeed been the backbone of arguments favouring private ownership in respect of productive efficiency, but this motive would only be applicable in cases of relatively small owner-managed firms, where owners participate in administrative and operational decisions and where they are in a position to control the performance of their employees. With direct and well-defined property rights, managers will be in the position to restrain employees from behaving in an indiscretionary manner for their personal benefit (Killick and Commander, 1988:1470). In these cases the owner-managed private firm has an advantage over the public firm, because the performance of managers is directly related to the return on their investment, whereas public managers are civil servants with no such financial stake in the profits of the firm. It could therefore be said that shareholding by managers and employees is an important motivational force towards productive efficiency.

In respect of larger private firms, however, it is debatable what degree of owner shareholding is required to render this motive effective. In many countries managerial shareholding and worker participation schemes have been introduced with limited success. Small nominal shareholding does not empower the worker with effective control. This could lead to frustrated ownership, which is not at all conducive to a motivated work force. If workers could be persuaded that their contribution to productive efficiency would strengthen the value of their shares, the incentive would be real. However, the capital gain for the shareholding employee is relatively small. The Marxist critique that workers are alienated from the product of their labour is true to the extent that a free-rider problem exists and that workers in large firms do not experience a direct correlation between the amount of effort invested by them and the size of their remuneration. This motive is only truly effective in the case of the traditional owner-managed firm.

5.3.3.2 The public firm

Public ownership, on the other hand, exhibits certain disincentives in respect of profit-maximisation and productive efficiency. Firstly, as Van de Walle (1989:605) points out, managerial incentives to maximise profits and minimise costs are undermined by the tendency of politicians to set inconsistent and contradictory goals for public managers. The enforcement of different political goals, creates confusion with public managers as to which results they are expected to achieve.

A basic precondition for a motivated management is that they should know exactly what to do to satisfy their superiors and to qualify for promotion. If they are required simultaneously to pursue contradictory goals such as the expansion of the work force as well as the maximisation of profits, it is to be expected that their vision will be clouded and their motivation repressed. Especially in developing countries, politicians often force public enterprises to overstretch their limited managerial and administrative capacities with too many peripheral activities, and consequently to sacrifice productive efficiency (Van de Walle: 1989:606).

Secondly, the public sector has experienced difficulties in reconciling the efficiency objectives of the firm with personal goals of bureaucrats or public managers. Such a situation is a perfect breeding ground for productive inefficiency. The personal motives and objectives of bureaucrats are usually inconsistent with that of profit maximisation and include the maximisation of salaries, perquisites, power and social standing (Niskanen, 1971). In the absence of the profit motive, public managers will tend to pursue other broad goals such as budget maximisation, risk aversion and over-manning. The above-mentioned confusion of objectives also makes it difficult to introduce managerial incentive schemes in the public firm. In the light of the lack of effective performance monitoring mechanisms in the public sector (which will be discussed later), managers and employees have the freedom to pursue personal goals, such as promotion and salary increases, to the detriment of the firm. Personal ambition could be pursued without working harder because efficiency is rarely the main criterion in determining remuneration packages. Seniority in the firm and loyalty to superiors instead of efficiency are often used as criteria in promotion decisions. This means that public managers and employees could indulge in organisational slack and easy working conditions without endangering their future career opportunities.

In the private sector, however, managers and employees receive salaries which are more directly linked to profitability and productivity than their public counterparts (Nellis and Kikeri, 1989:663). Promotion, remuneration and performance are closely aligned. Private managers are also given a simpler yet more demanding set of signals and incentives aimed at achieving efficiency objectives of the firm (Nellis and Kikeri, 1989:663). Private managers, who want to satisfy their personal ambition, are in a better position than public managers to influence the size of their salaries and the progress in their careers by improving the efficiency of their performance.

Thirdly, public managers and bureaucrats tend to have an input approach towards productive efficiency. They seem to be preoccupied with the maximisation of budgeted costs and its reconciliation with actual costs, and not with the minimisation of both. Bureaucrats will favour the expansion of staff, because more hands to do the same quantity of work will give more idle time during which they could pursue personal objectives. Public managers will also favour a recruitment drive, because their social standing and power tend to grow in stature with the amount of subordinates having to report to them. Bureaucratic objectives are strongly related to the size of the government grant allocated to individual public firms. Surplus government funds will be used to finance inefficient behaviour. It will also boost the budget of the public firm which again contributes to the social standing of public managers. It therefore follows that bureaucrats are budget-maximisers and will use their lobbying power to obtain larger government grants (Brown and Jackson, 1986:172). Bureaucrats would also be tempted to misrepresent information and exaggerate the needs of the public enterprise in order to secure a larger share of the central budget. In the private sector, on the other hand, emphasis is placed on the minimisation of inputs (costs) in order to produce the maximum output. Furthermore, managers within the public sector are motivated and their careers advanced not by taking innovative risks, but by meeting targets and by avoiding mistakes (Murray, 1987). In the private sector risk-taking and over-achievement are usually rewarded with higher profits and remuneration, whereas very few similar managerial incentives exist in the public sector (Murray, 1987). Bureaucratic rules and procedures in the public sector have the effect of preventing innovative or exceptional managerial performance. There are also very few mechanisms which could account for and monitor such performance. There is thus an important difference in the mental approach of public and private managers which can be related to the form of ownership.

Fourthly, the public enterprise has a poor reputation regarding corruption resulting in the personal enrichment of public managers and employees (Dreyfus, 1980:208). Roy (1980:47) maintains that although corruption does not occur exclusively in the public sector, the opportunities are greater in public enterprise than in private. The reasons for this are closely related to the separation of ownership and control as well as the concomitant lack of proper performance monitoring which will be discussed later. A few other possible causes are worth mentioning. The large size of the usually large bureaucratic machine makes it difficult to asses the origin of corruption and mistakes. Bureaucratic rules could also be used by politicians and managers to conceal errors and to prevent detrimental political publicity. Especially in strategic enterprises, e.g. arms and gas, employees are entrusted with clandestine responsibilities and have no duty to disclose information. Within such an environment, corrupt officials will have ample opportunity to misappropriate scarce resources for their personal enrichment. Haile-Mariam and Mengistu (1988:1570) observe that public enterprises in third world countries, e.g. Mobutu's Zaire and Marcos's Philippines, have become a vehicle for corruption and nepotism.

5.3.3.3 The managerial firm

The rise of the managerial firm called for a reconsideration of the standard view of profit maximisation as the guiding behavioural postulate. The "property rights" school deviated from the mainstream theory, focusing instead on the actions and personal needs of managers in pursuing their self-interest (Killick and Commander, 1988:1470). The utility maximising model was used to explain the behaviour of the firm by observing the actions of individuals within the firm (Furubotn and Pejovich, 1972:1138). Baumol (1967) added that except for a minimum acceptable dividend necessary to satisfy the shareholders, the resources of the managerial firm are used to maximise managerial utility and provide on-the-job amenities. Such amenities include the maximisation of managerial wages and the size of the firm. Profits are sacrificed for utilities such as prestige, good labour relations, quiet life, liquidity, security or protected working conditions (Boulding, 1960:4).

The managerial firm introduces a class of professional business managers who are employed by the firm and who perform their administrative duties irrespective of receiving a marginal incentive in profit-sharing (Roy, 1980:46)). An important distinction between the modern corporation and the classical firm is that the owners of the former have reduced ability to revise or terminate the membership of the firm i.e. the management. The attenuation of owner's rights in their firms takes the form of a reduced ability to control managerial decision-making (Furubotn and Pejovich, 1972:1149). In such a firm, neither the small shareholder with diluted ownership, nor the non-profit-sharing professional manager will have the incentive to ensure that the goal of profit maximisation is enthusiastically pursued. This separation of ownership and control in the managerial firm means the demise of strong property rights, leaving managers with more discretionary power to pursue their own ends.

According to Monsen and Downs (1972:368), the professional managers are "*economic men who desire to maximise their own lifetime incomes, principally by obtaining rapid promotions as a result of pleasing their superiors in the firm*". These lifetime incomes include both monetary and non-monetary elements. The problem is that the monetary incomes of managers do not vary in strict relation to the firms profits and they are therefore not encouraged to serve the firm's interest by maximising their own income. Instead, managers will primarily try to maximise their own lifetime income which includes non-monetary elements namely power, security, leisure and prestige. These elements reduce productive efficiency and are contrary to the interests of owners and other managers of the firm (Monsen and Downs, 1972:355). Managers will, for example, seek to expand expense-account benefits in order to raise their total compensation without attracting too much attention from the owners. Managers and directors will also be keen to increase the size and diversity of their firm in order to enhance their personal prestige and remuneration (Gerson, 1990:4). Individuals within the firm may furthermore be tempted to shirk as long as the cost of shirking could not be fully determined and could be shifted onto others. In this way professional managers could engage in discretionary behaviour by appropriating for themselves those benefits that would otherwise have accrued to the owners. The size of the infringement on the owners' interests will depend largely on the ability of owners to check managerial behaviour and to keep it in line with their own objectives (Furubotn and Pejovich, 1972:1147-1148).

The argument that managerial behaviour in modern managerial firms is not driven by firm orientated interest towards the maximisation of productive efficiency and profits seriously endangers the advantage that private enterprise has over its public counterpart. In fact, it can be argued that the behaviour of professional managers in private firms, in response to utility maximising incentive structures, is not superior to bureaucratic managerial behaviour in public enterprises.

Three important arguments should however be raised to put this criticism in perspective and to tip the scale in favour of the private managerial firm. In the first place, as Demsetz (1988(b):192-193) points out, the diffused ownership managerial firm does not necessarily give rise to more on-the-job consumption, and therefore productive inefficiency, than the owner-managed firm. He argues that the owner-manager will not refrain from sacrificing profit for more on-the-job consumption as long as his/her personal utility is maximised. The owner-manager may eventually be pleased to retire to the role of specialised owner and appoint professional managers to run the firm. Although owners do not derive any benefit from the on-the-job consumption of their managers, they will seldom be in a position to prevent such managerial behaviour, because of high monitoring costs. Owners will therefore endeavour to neutralise such on-the-job-consumption by a cut in managerial salaries. In this way total production costs will remain unchanged. In the public sector it will be more difficult to cut wages because of the stronger lobbying power of civil servants.

On the other hand, Furubotn and Pejovich (1972:1152) argue that individuals prefer money income over the consumption of non-pecuniary goods, because the former offers a greater variety of choices. If managerial salaries were to be decreased to cover the full costs to owners of non-pecuniary consumption by managers, then labour supply would be expected to decrease to such an extent that market forces will push up salaries. They do, however, admit that managerial firms with a dispersed ownership structure might have a special productivity advantage over less dispersed firms enabling them to finance the costs of non-pecuniary consumption. It is not certain what constitutes such a productivity advantage but its existence is evident from the fact that the price level in dispersed ownership firms is lower than expected.

Alchian (1969:349) suggests that the advantage lies in the availability of cheaper information due to the fact that specialists are called upon to collect and evaluate information while being more fully rewarded for the task. The managerial firm has superior internal markets for exchange and reallocation of resources. These "knowledge effects" are turned into beneficial internalities and rewards to those producing them.

In the second place, the specialisation of business activity into the different tasks of owning and managing, raises the utility levels of those with funds to invest and those with managerial skills to sell (Demsetz, 1988(b):192). Had it not been for the separation of ownership and control, potential owners would not have been able to combine their capital with the best available managerial know-how. Specialised professional management in fact improves productive efficiency, especially in those fields which require a high degree of expertise. The separation and specialisation of share-ownership and managerial control, lower the cost to society and create opportunities that would otherwise have been unexploited (Demsetz, 1988(b):192).

In the third place, the market for professional managers in the private sector is more specialised and open than in the public sector. Appointments of professional managers are usually done on the basis of technical know-how and competency.

On these grounds successful outsiders could be preferred ahead of contenders from within the firm. Efficiency will always be an important criterion in the selection process of the private sector, even though personal motives may come to the fore after appointment. This criterion is entrenched in the private sector in the light of its tradition of efficiency relative to the public sector. On the other hand, bureaucratic appointments are often made on the basis of internal ranking and not competence. The person next in line will be favoured and outsiders rarely stand a chance.

In the fourth place, Furubotn and Pejovich (1972:1150-1151) believe that heavy competition between managers could exist against the backdrop of a strong corporate culture. Managers are motivated to move to better jobs by superior performance on present jobs. They will furthermore have the incentive to disclose inefficiency in the behaviour of other managers and thereby gaining personal advancement in their own careers. Such competition between managers from different firms could contribute much to the elimination of productive inefficiency in the managerial firm.

5.4 PERFORMANCE MONITORING

5.4.1 Private vs public firms

On the assumption that a positive correlation exists between the effectiveness of performance monitoring by the owners of a firm and the productive efficiency of its management, an analysis will now be made of the monitoring capacity of the private and public firm respectively.

In the private owner-managed firm, those whose capital is at risk (private owners) exercise direct supervision over managerial behaviour and thoroughly scrutinize the activities of the firm. Not only will controlling shareholders perform high quality performance monitoring, but they will also refrain from indulging themselves at the expense of the firm, because they always bear at least a portion of the costs (Gerson, 1990:3). The small private firm has the advantage that rights to profits are clearly defined, and those who exercise these rights have strong incentives to supervise management carefully to prevent any form of slack and shirking. Another advantage of the small private firm is that the hierarchy of authority is less complicated than in the case of the public firm. Owners are better informed and a general duty rests on managers to disclose information. Shareholders also have a strong interest in efficient management and vote separately on different issues pertaining management. Although the small shareholder is mostly apathetic and only the controlling majority shareholder has the motivation to monitor carefully, it is the effective monitoring by the latter that ensures high levels of efficiency.

The ideal situation is thorough supervision by relatively large, self-interested shareholders imposing commercial profitability as main criterion for judging managerial performance.

In the public sector the incentives to monitor managerial performance are poor and managers have considerable discretion to pursue their personal agendas. This should be seen in the light of the separation of ownership and control in the public sector as fully discussed above. The absence of shareholders with a direct interest in profits alleviate the pressure on managers to maximise company performance (Van de Walle; 1989:605). According to the "property rights" literature, bad performance in the public sector could often be ascribed to ill-defined, diffused and uncertain property rights (De Alessi, 1980:44). Public sector managers are responsible to politicians who represent the real owners, i.e. the public. However, the political process is too cumbrous and complex and characterised by too much bureaucratic slack to function efficiently as monitoring system for managerial performance. The fact that voters do not vote separately for different policies, but have to cast a single vote in favour of a complex package of policies, restricting their monitoring power. The stake of every citizen in any single public firm is also too small for it to render a real incentive to monitor efficiency within the firm.

Politicians, as vote maximisers, also have little incentive to monitor zealously, because their political popularity is more sensitive to macro-economic indicators than to the performance of individual corporations. If they do monitor and discover bureaucratic inefficiency, they will find it to be politically more glamorous to articulate the problem than to actually implement policies aimed at addressing them (Peacock,1980:35). However, the opportunity costs of monitoring bureaucratic activity may be too high for ambitious politicians. They will probably find that it is not in their personal political interest to cut out the bureaucratic waste that they have unveiled. Civil servants and private interest groups who benefit from such bureaucratic waste or inefficient subsidy programmes will surely use all their lobbying power as voters to resist the implementation of proposed trimming measures. In the words of Peacock (1980:35), *"politicians are not likely to greet their constituents with the news that they are unwilling to facilitate their entrée to reap the benefits which bureaucrats may control by their discretionary powers".*

5.4.2 The managerial firm

Many advantages that private ownership held over public ownership in respect of performance monitoring, were sacrificed with the rise of the managerial firm. Owners of managerial firms are by nature profit-maximisers and will be motivated actively to strive for productive efficiency. In order to translate this motivation into action, they must be in a position to monitor and influence managerial behaviour to ensure that it is in accordance with these motivations. There are, however, certain limitations preventing them from monitoring management effectively. An important limitation is that the managerial firm is characterised by the separation of ownership (shareholders) and control (management) as well as by the diffusion and proliferation of shareholders. These characteristics contribute to a lack of performance monitoring and therefore reduced productive efficiency.

It is important to elaborate on the diffusion and proliferation of shareholding in the managerial firm in order to analyse the capacity of owners effectively to monitor performance within the firm. Demsetz and Lehn (Demsetz, 1988(b):196-205) explain the proliferation of ownership as follows. Managerial firms in certain industries require large scale production in order to maximise profit. A larger competitively viable size requires an expansion of the firm's capital resources, which again means a rise in the market value of a given fraction of ownership. The fact that individual investors must now invest more to obtain a given fraction of ownership should, in itself, reduce the degree to which ownership is concentrated. In other words, scale requirements create the need for large scale equity capital to the effect that a diffuse ownership structure is inevitable. In order to maintain a concentrated ownership structure, existing owners can provide additional capital themselves by committing more of their personal wealth to a single enterprise. However, risk aversion implies that they will only buy additional shares at reduced, risk-compensating prices. This could persuade owners to relinquish the structure of concentrated ownership. If this happens and the number of shareholders increases, the wealth of each investor is less dependent on the success of a single firm. Investors have the opportunity to diversify and to spread their risks by investing in a variety of concerns. The more diffuse the ownership becomes, however, the more difficult it will be to implement effective performance monitoring by shareholders with relatively small shareholding.

Demsetz and Lehn (Demsetz, 1988(b):202) furthermore submit that such diffusion of ownership creates the incentive for shirking by minority shareholders in the sense that the costs of spending their time on pursuing other personal interests rather than on monitoring managerial performance are borne by all the shareholders in proportion to the number of shares owned by each. The more concentrated the ownership, the more responsibility will be on every shareholder to apply his/her mind, time and effort more diligently to the interests of the firm, because the costs for failing to do so will be spread over fewer owners.

The diffusion of shareholding further contributes to the separation of ownership and control, which (as discussed above) is prevalent in the managerial firm. Together, these attributes cause already isolated shareholders to be further removed from the firm's actual affairs. De facto ownership, dispersed across a large number of shareholders and separated from management, is stripped from its control function and converted into de jure ownership. The shareholding of the individual owner is simply too small and too remote to render effective control over managerial performance.

Furthermore, managerial activities in large managerial firms are growing in complexity and calls for expert knowledge and specialised experience. Shareholders are therefore also intellectually separated from management. Consequently, shareholders are generally ignorant of day to day managerial decisions and of alternative policies available to the firm (Monsen and Downs, 1972:353). This, together with their inability to judge and act upon small deviations in quality of performance, hamper shareholders in their task of monitoring productive efficiency. In view of rising capital costs, risk-aversion objectives and a lack of managerial expertise, shareholders have no choice but to accept a more diffuse ownership structure and a reduced capacity to monitor managerial performance. This choice would be consistent with shareholder utility-maximising behaviour. Shareholders will then leave the task of managing the firm and monitoring performance to professional managers, whom they appoint, and rather concentrate on their specialised task as investors and owners.

The deterioration of the monitoring ability in the managerial firm has serious implications for productive efficiency. The lack of effective monitoring creates an environment in which corporate managers have the freedom to strive for the maximisation of their own interests (as discussed above) instead of owners' objectives related to profit maximisation. The conflict of interests between managers and owners is resolved in favour of corporate managers, due to the lack of powerful monitoring owners. If it is assumed that managerial interests do not necessarily coincide with those of shareholders, the effect of such lack of control will be that corporate resources are not used entirely in pursuit of shareholder profit. Veblen (1924) and Galbraith (1968) maintain that a positive relationship exists between ownership concentration and the profit rate.

Haile-Mariam and Mengistu (1988:1584) hold the view that the attenuation of ownership and the abdication of control by owners apply to the owner-shareholder in a private managerial firm as well as in a public enterprise. For reasons already discussed, the private shareholder has to revert to a hands-off approach and cannot influence managerial decisions on a day to day basis. Shareholder's rights are limited to electing and removing directors and ensuring that they abide by the applicable state laws, articles of incorporation and common law. It is submitted, however, that the real owners of the public firm, i.e. the citizens, are even further removed from its daily affairs and that ownership is also more proliferated than in the case of the private managerial firm, due to the nature of the political process.

5.4.3 Problem areas

Several problem areas hamper improved performance monitoring by shareholders in private managerial firms. Firstly, shareholders of the managerial firm usually entrust the board of directors with the task of monitoring managerial performance. The board of directors, however, are restricted in their ability to monitor managerial performance. They lack the necessary autonomy, because top management usually controls the board through proxy agreements and through the representation of key executives on the board. Key executives are therefore self-perpetuating and will be dismissed only in the case of blatant misconduct (Monsen and Downs, 1972:354).

Secondly, the basic problem encountered by shareholders is the high cost of gathering information on managerial inefficiency. Managers who control the dissemination of information regarding the activities of the firm, will tend to conceal unfavourable data from shareholders and directors. According to Tullock* (Monsen and Downs, 1972:358-361) managers at every level will tend to screen information

* "A General Theory of Politics" (undated and unpublished mimeographed manuscript), discussed in Monsen and Downs.

in their possession so that only data favourable to themselves will be passed on to their superiors. Because they are in no position to pressure management in maximising profits, owners of managerial firms will revert to the role of satisficers who desire satisfactory growth in profits, uninterrupted dividends and a gradual appreciation of the market price of shares (Monsen and Downs, 1972:352,368).

Thirdly, the large size of the managerial firm causes it to develop a bureaucratic management structure which cannot be effectively controlled by those in charge (Monsen and Downs, 1972:356-361). Managers are forced to delegate authority to employees, but are at the same time prevented from fully monitoring use of that authority (Monsen and Downs, 1972:369). This causes the management systematically to deviate from ownership objectives as discussed above. The bureaucratic structure makes it impossible for efficient control of managers by owners and of employees by managers.

Fourthly, since it is difficult to measure the individual contributions to the firm's profits, managers are inclined to pursue policies that serve their own objectives instead of that of the firm. Superiors will also be pleased by and promote those subordinates who pose no threat to their positions as managers, and who will further their personal interests even if it may impair the firm's efficiency. In this way distorted performance criteria are laid down by management.

Fifthly, the power struggle between owners and managers over who will have control over surplus funds generated within the firm is presently being resolved in favour of managers; thereby depriving shareholders not only of their role as capital providers, but also of an important incentive to monitor productive efficiency. If all surplus funds were to be paid out to shareholders in the form of annual dividends, they would have the opportunity to reconsider their investment on a regular basis. They would be motivated to monitor the firm's performance in order to decide whether to reinvest or disinvest such funds. Such continuous monitoring incentive would certainly keep management alert and efficient.

However, according to Jensen (Goodman and Loveman, 1991:35) managers have been consistently unwilling to reward owners with dividend payouts, preferring to hold on to surpluses. They are reluctant to do so for a number of reasons. Firstly, is in the interest of managers to prevent owners from voting with their capital and making new decisions on how to invest the surplus capital. They would not want to be in a position where they continuously have to persuade shareholders to reinvest surplus funds rather than diverting it to more efficient investment opportunities. Another reason is that retained profits and excess cash provide managers with autonomy vis-à-vis the capital markets. They are relieved from the thorough scrutiny of capital providers as well as from their responsibility to convince the capital markets anew to supply funds as sound economic projects arise (Jensen, 1989:66). Free cash flow, i.e. cash flow in excess of that required to fund all investment projects with positive net present values, should rather be distributed to shareholders in order to maximise the efficiency and value of the firm. However, very few mechanisms or incentives exist to compel or motivate managers to distribute these funds. Jensen (1989:66) reports that in 1988, the

1000 largest companies in the USA generated a cash flow of $1,6 billion of which less than 10% were distributed as dividends or share repurchases.

Finally, excess cash provides managers with the opportunity to increase the size of the firms they run beyond that which maximises shareholder wealth, through capacity expansion and diversification (Goodman and Loveman, 1991:35). Managers have the incentive to maximise company size as a goal in itself, because executive salaries are strongly related to increases in corporate size rather than value (as discussed above) (Jensen, 1989:66). Corporate growth also enhances the social stature, public prestige and political power of senior executives. Managers typically justify their endeavours to increase the size and diversity of the firm by explaining that it is aimed at reducing the risk to shareholders. Gerson (1990:4) maintains, however, that the onus should be on shareholders themselves to diversify their portfolios by investing in several different companies, and not on the single firm to diversify its activities to the extent that it incurs efficiency losses stemming from the lack of expertise in the new lines of business. The real motive behind this managerial goal is more probably that managers would want to reduce their own vulnerability and enhance their personal prestige.

The independence from capital markets, the availability of large cash balances and the incentive of maximising corporate size, have tempted managers, especially those in industries with little long term growth potential, to waste funds on investments with low returns and to apply it in an inefficient way (Jensen, 1989:66-67). The result is not only the inefficient allocation of scarce funds but also the dissipation thereof through productive inefficiency and waste without being checked by the scrutiny of shareholders.

5.4.4 Monitoring benefits of the managerial firm

Notwithstanding the above-mentioned problems, a case could still be made out in favour of the private managerial firm vis-à-vis the public firm in respect of performance monitoring by owners. In the first place, ownership and control are more separated in the public sector than in the case of the private managerial firm. As explained above, shareholders in the managerial firm could pressure management by threatening to vote with their feet and change their investment. An important difference between the right of a citizen in a state where public enterprises are operating, and a shareholder of a private managerial firm, is the right of the private shareholder to buy and sell shares (Haile-Mariam and Mengistu, 1988:1584). Citizens can indeed influence managerial policy in the long term by exercising their political voting power. The political process is, however, a cumbrous and long-winded way to control managerial behaviour. Citizens cannot vote when they are dissatisfied, but have to wait for a general election. Between elections they can only raise their complaints with political representatives who could put pressure on public managers via the appropriate minister. The unavailability of information, the complexity of the channels of authority and the inability of citizens to invest or disinvest individually, renders monitoring by the true owners of public enterprises over management highly ineffective. Disillusioned shareholders in the managerial firm will at least as a last resort have an incentive to monitor managerial behaviour when they decide on whether to sell their shares. The information basis for such monitoring will be better than in the public sector, because of the statutory obligation on the managerial firm (especially if listed on the stock exchange) to disclose minimum information on profits and losses.

The incentive to monitor will also be strengthened by the payment of dividends to shareholders. On receipt of a dividend, shareholders are forced to evaluate the firm's performance, in order to decide whether to reinvest the dividend in the same firm or to look for more profitable investment opportunities. If no dividends are paid out, it would be a signal to shareholders that something is wrong and that their investment may be at risk. In this way the shareholders will maintain interest in the performance of the firm. It could therefore be argued that private ownership will still be preferable to public ownership, because of this residual incentive to monitor managerial performance.

In the second place, Demsetz (1988(b):194-197) asserts that the ownership structure of the modern managerial firm is endogenously determined by competitive selection in which various cost advantages and disadvantages are balanced to arrive at an equilibrium form of organisation. He treats monitoring cost on a par with any other production cost. In the case of the high-monitoring cost business, owners will be inclined to cut managerial salaries, but allow considerable on-the-job consumption. Production costs will thereby stay the same as managers are being paid according to their productivity. Equilibrium will be achieved when the sum of the on-the-job consumption and salaries will equal the production cost in the low-monitoring cost firm where on-the-job consumption is restricted and managerial salaries increased. In this way provision is made within the managerial market for different preferences of managers regarding the composition of their total remuneration, i.e. pecuniary and non-pecuniary components. In the public sector, however, it is difficult to adjust managerial salaries downward to maintain such equilibrium, because of the large bureaucratic structure and the strong bargaining power of public trade unions.

In the third place, there exists some scope for concentration of ownership in the managerial firm. Especially in small economies, there usually are majority shareholders who have the incentive to monitor managerial performance. Even if no majority shareholders exist, Demsetz (1988(b):197-200) avers that *"...dispersed ownership will become sufficiently concentrated to give proper guidance to, perhaps to boot out, an inefficient management"*. Small shareholders could decide to form ad hoc power blocs with other shareholders when it is necessary to act strongly against inefficient management. The mere possibility of concentration of shareholding by way of concerted action or take-overs will keep managers in check, as already discussed. However, the process of concentrating ownership is very costly and will only be embarked upon as a last resort. Demsetz (1988:198) argues that a more direct linking of the interests of ownership and control is necessary to safeguard productive efficiency. The self-interest of shareholders suggests that they will not easily abandon their control over their assets, except to those who have similar interests. They could be persuaded to entrust their control to top management, especially in those cases where the interests of management and owners are kept in line by incentive schemes, for example stock-based managerial compensation and management shareholding. The mere fact therefore that shareholders entrust the management of their capital to professional managers, must at least mean that the goals and motivations of such managers could not be too much out of line with that of their own. Gerson (1990:4) added that managerial abuse could be curbed by tough and powerful controlling shareholders, even if it means a further concentration of ownership. He therefore regards potential managerial abuse in diffused ownership firms as a more serious threat to productive efficiency than the potential "abuse" by strong controlling owners. A strong argument could be made out favouring a concentrated ownership structure in the light of the efficiency benefits of more effective monitoring.

In the fourth place, there is empirical evidence to the effect that the diffuse ownership structure of the private managerial firm, is not significantly related to lower profit rates or productive inefficiency in the private sector. Demsetz and Lehn (Demsetz, 1988(b):202) studied ownership data from 511 major US firms and found no significant correlation between the degree of ownership concentration or diffusion and the profit rate. They argue that the higher cost and reduced profits associated with a more diffuse ownership structure and the loosening of control of professional management, could be neutralised by lower capital acquisition cost or other profit enhancing aspects of diffuse ownership. Unfortunately, they do not expand on this simple explanation. If such evidence should be corroborated, however, a case could possibly be made out that the separation of ownership and control has a less detrimental effect on productive efficiency in the private than in the public sector. This will be the case if the public firm do not have the corresponding advantage of lower capital acquisition cost related to a diffuse ownership structure. Included in the costs of capital acquisition in the public sector, is the loss of incentives due to the distortions created by raised taxes.

In the fifth place, the managerial control over surplus funds and the consequent lack of performance monitoring by capital markets have to be addressed. A solution gaining ground in the USA is the phenomenon of Leveraged Buyouts whereby constituent parts of dismembered conglomerates are sold to managers who then run the firm as controlling shareholders with a greater incentive to monitor efficiently (Gerson, 1990:5). Debts in the form of junk bonds replace equity as the source of capital.

Gerson (1990:5) argues that *"with all the right incentives and with the whip of debt-servicing payments cracking over their heads they can be expected to run hard and to spare no effort".* Financial institutions, as capital suppliers, have considerable expertise and experience in monitoring managerial efficiency, and could prove to be an adequate replacement for monitoring by shareholders. They have a concentrated interest in the debtor firm and real financial incentives to monitor the way in which their funds are utilised.

5.5 RENT-SEEKING COSTS

For a variety of socio-political reasons, government policies are sometimes designed to maintain economic rents at artificially high levels by way of tariffs, input quotas, entry regulations and restrictions on competition. The existence of economic rent will trigger managerial effort aimed at capturing this rent. Rent-seeking efforts in this sense are wasteful per se and could prevail in the public or private sectors of the economy.

Bureaucratic managers of public enterprises have ample opportunity and motivation to practice rent-seeking activities and turn government policies and regulations in their favour. As discussed above, public managers adopt an input approach to management. Higher costs and inefficiency will support their quest for more government assistance. The costs of lobbying for government favours are wasteful per se, because it is not aimed at producing goods or services more efficiently (Buchanan and Flowers, 1987:118-124). It may well result in surplus funds for the individual firm, but part of it will be consumed by the very endeavours to acquire them. Managers will spend a lot of time and effort persuading politicians to raise subsidies rather than trying to remove the rationale behind it, namely productive inefficiency. Once government assistance has been obtained, public managers will again try to waste it by way of managerial slack and inefficiency in order to create the opportunity for further rent-seeking.

Paul Starr (1987) contends that profit-seeking private enterprises (especially large managerial firms) servicing public amenities will find it in their interest to lobby for expanded public spending with no less vigour than did their public sector predecessors. Although, rent-seeking also occurs in the private sector, it is submitted that more incentives for rent-seeking exists within the public sector. Public managers have easier access to the central budget via the political hierarchy and could be more tempted to indulge in these unproductive activities. In the private sector, however, there is a way in which rent-seeking activities could be controlled and minimised. The right to capture the economic rent created by government policies could be auctioned by way of a competitive bidding process. The winning bid would be more or less equal to the available rent, offering only normal profits to the "winner". The funds saved in this way could also be channelled back to the people by not raising taxes.

5.6 INNOVATION

Except in the case of explicit government policy to the contrary, public enterprises spend less on research and the development of cost saving innovations than their private counterparts. Murray (1987), in arguing a case for the public enterprise, admitted that the performance of the public sector in respect of innovation had been poor. This means that public enterprises often lack the much needed technology to obtain dynamic productive efficiency. Instead, the surpluses generated by public enterprises are used to cross-subsidise other industries, to inflate salaries or to improve working conditions under the pressure of trade unions.

Public managers and employees who want to avoid the risk and extra responsibility of a research and development programme, may also be tempted to dissipate the surplus through the bureaucratic slack and x-inefficiency. The result is that public firms are often over-capitalised with outdated technology. This would mean long term productive inefficiency in the public sector.

Wolf (1979:120-122) suggests that a bias against new technology in some state departments could lead to productive inefficiency. The education industry in the USA for example resisted the experimental use of computer-aided instruction, which might reduce the demand for teachers, and stuck to the notion that "familiar and simple is better". Wolf also argues that in some other public institutions like the military services and space programmes, the contrary applies in that the goal of technological development is pursued to the extent that productive efficiency is reduced. The latter is conducive to budget-maximising behaviour resulting in over-supply (as discussed in the previous chapter). It is further submitted that such a bias towards technological development in the public sector, will only exist in respect of industries where vigorous international competition exists (e.g. military and medical).

Schumpeter (1954:Chap 7) held the view that large modern corporations and private monopolies have greater incentives to undertake cost-saving technical innovations by way of research and development than the smaller competitive firms. The freedom from competitive pressures act as a spur to innovative investment since the monopoly profits enable the firm to risk the expenditure without the possibility of free-riding competitors sharing the benefits of investment without paying for it (Tregenna-Piggott, 1980:68). Large firms have greater resources available for research and development and could expect a higher potential return on any successful venture. These factors provide the incentives to the modern corporation to spend more on technical advances which, if successful, could lead to the reduction in costs and the possible expansion of output.

Another factor in favour of the large modern corporation is that financial institutions are more willing to support large profitable corporations. These corporations would of course be in a favourable position to fund the greater part of the costs of research and development internally by the application of retained profits. As argued earlier, the modern managerial firm is inclined to pile up cash reserves instead of paying out dividends to shareholders. An example of this is the Ford Motor Company sitting with cash reserves of $15 billion in 1989 (Jensen, 1989:66). Apart from the availability of funds, most Western economies operate a patent system, offering inventors a temporary legal monopoly for a fixed period before competitors could reap the benefits of the inventor's initial investment in research and development. Patents offer essential incentives to inventive corporations, but the fact that it is only temporary, means that the benefits of research and development will eventually trickle down through the whole economy, thereby lowering costs and enhancing productive efficiency. This would involve an outward shift of the production possibility curve.

5.7 COMPETENCY

Roy (1980:46) asserts that the incompetency of public managers is an important contributory factor to the productive inefficiency of the public enterprise. The incompetency often arises from the fact that public managers are chosen for reasons other than capability, most notably political reasons.

This is especially the case in the event of a change of government in developing countries. The new regime will be pressured by its constituency to reward party loyalties with jobs in the government administration and in the management of public enterprises. A benign corps of officials and managers could facilitate the implementation of a new economic policy, while a hostile corps could be in a position to slow down the process of change considerably. With every change in government a degree of affirmative action will take place on this level. If however, this policy goes too far and incumbent management is replaced without consideration being given to competency and experience, the cost will be high in terms of productive inefficiency.

After the first democratic elections in South Africa in 1994, it became clear that affirmative action was going to be a priority in the Reconstruction and Development Programme of the Government of National Unity. The public sector was the natural starting point and nearly all the new appointees in state departments were from previously disadvantaged segments of society. The effect thereof on productive efficiency will have to be monitored, but will probably be negative in the light of the lack of expertise and experience of the new appointees. The firm will incur additional costs in the form of extra training and supervision in an attempt to close the productivity gap (Black, 1995:7).

According to Van de Walle (1989:606), the most serious constraints on public policy are not to be found in its design, but in its implementation by extremely thin administrative hierarchies with limited means and capabilities. The administrations are simply not sophisticated enough to process available information efficiently, to apply it to a variety of political and economic goals, and to adjust quickly to new and changing circumstances.

5.8 SUMMARY

In this chapter it was illustrated that the conventional private firm has an undisputed advantage over the public firm in respect of productive efficiency. The determining factors were discussed and it was then explained how the modern managerial firm sacrificed much of this high ground that it previously held over the public sector. The contemporary critique against the private managerial firm is that by the separation of ownership and management, the diffusion of ownership, the bureaucratic structures of management, the large size of the firm, the complexity of management as well as the divergence of motives and goals, productive efficiency has been reduced. The separation of ownership and control had the effect of overriding managerial incentives to be efficient and reducing owners' capacity to monitor managerial performance. Diffused ownership caused shareholders to lose interest in the day to day management of the firm and to revert to a hands-off approach. A bureaucratic structure provided ample opportunity for the concealment of inefficiency and the pursuit of contradictory self-interests. The large size of the firm and complexity of management, coupled with the limited capacity of managers, reduced the effectiveness of monitoring delegated authority by superiors. A divergence of motives and goals caused this delegation to result in inefficiency.

However, a case has been made out that, notwithstanding the above-mentioned sacrifices, productive efficiency is still higher in the private managerial firm than in its public counterpart, in respect of each of the conventional factors mentioned above.

CHAPTER 6: SYNOPSIS

The debate on whether public or private ownership of firms renders the most efficient outcome, both in the allocative and productive sense, has altered drastically along with the change in the organisational and market structure of the modern firm. A synopsis of the argument, in respect of the allocative and productive efficiency set out in the preceding chapters will be illustrated with the aid of Figure 6.

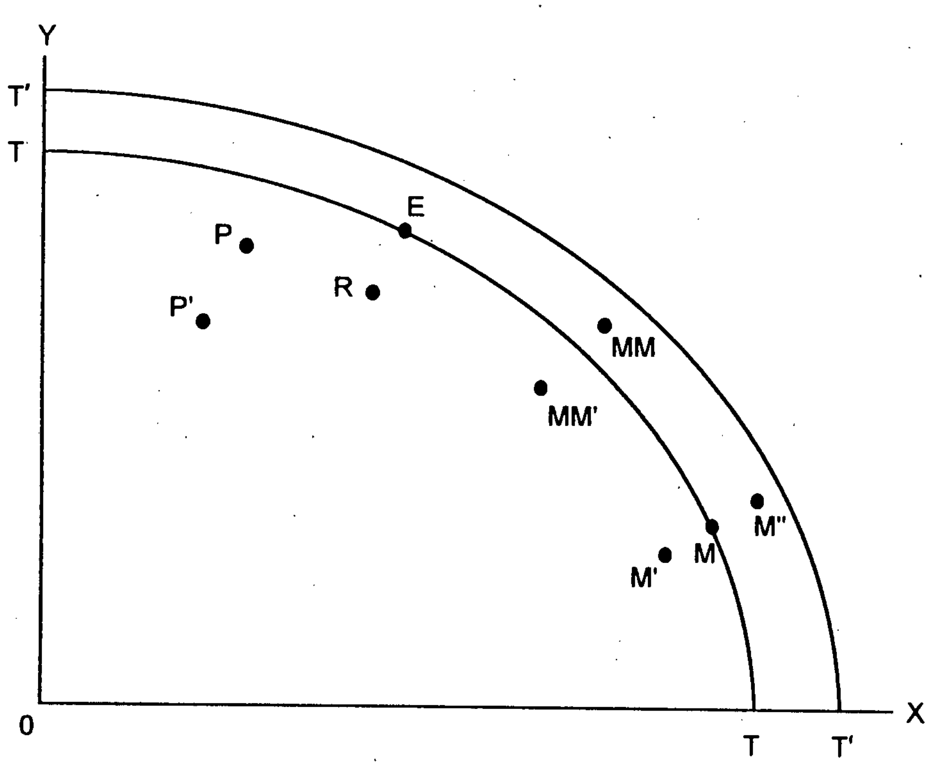

Figure 6

With the inception of the free-market system, based on private ownership, economies found it difficult to maintain acceptable levels of allocative efficiency. The neoclassical theory of perfect competition assumed that an invisible hand will guide the perfectly competitive market to an allocatively efficient equilibrium at point E where price equal marginal costs. However, it failed to take into account various market failures in the form of inadequate information, public goods, externalities, inequality and, most importantly, the lack of perfect competition and the presence of monopolies. The case of the natural monopoly is especially important, because, since it renders very little scope for the improvement of competition, the efficiency effects of a change in ownership could be measured more easily.

As discussed, the natural monopoly cannot maintain marginal cost pricing and reacts by undersupplying output while raising prices. The natural monopoly in Figure 6 is assumed to be sector Y, while sector X is perfectly competitive, and consequently the equilibrium of the privately owned monopoly will be at a point such as M. As a counter measure governments decided to control these firms either by way of regulating them or by taking over their ownership and then using such control to expand output by setting price equal to marginal cost. It should be pointed out that the intricacies of the regulation of the private firm fall outside the ambit of this dissertation and emphasis was instead placed on the effects of control through ownership. Under public control a higher level of allocative efficiency is obtained by increasing output and setting price equal to marginal cost. Allowing for the distortionary effect of a tax cum subsidy mix, the equilibrium will shift from point M to point R inside the production possibility curve (TT). This would mean an improvement of allocative efficiency if point R represents a higher social welfare than point M.

The rise of the public enterprise, however, created the environment in which public failure became a grim reality. The first cause of public failure was the deficiency of the political system and the resultant separation of ownership by citizens and control by politicians and bureaucrats. This has led to public enterprises being used by vote-maximising politicians as political instruments and by bureaucrats for the satisfaction of personal interests. The result was an oversupply of relatively unpopular public goods and a shift of the equilibrium from point R to point P, indicating a loss of allocative efficiency.

The rise of the modern managerial private firm introduced a firm with some similarities to the public firm in respect of its size and the separation of ownership by shareholders and control by management. However, some of these characteristics have the effect of inducing management to lower monopoly prices and expand output and thereby improving allocative efficiency. Sales maximisation replaced profit maximisation as behavioural postulate, while increased competition (actual or potential) among large enterprises as well as the growing importance of the public image of the modern conglomerate contributed to an increased level of allocative efficiency in the economy. The net effect of the rise of the modern managerial firm was a movement of the previous private equilibrium at point M along the production possibility curve to a point somewhere between points E and

M, the exact position of which will be dealt with below.

While the private sector had to struggle to restore its poor reputation regarding allocative efficiency, it always held the upper hand vis-à-vis the public sector in maintaining acceptable levels of productive efficiency. As discussed in the previous chapter, the lack of productive efficiency in the public firm can be explained by the severe pressure from trade unions, low levels of managerial motivation or incentives, as well as poor performance monitoring. Although productive efficiency is usually associated with the degree of competition in the market, the above-mentioned factors are inherent to the ownership of the firm, whether private or public, and their effects on productive efficiency support the argument that the privately owned monopoly could be expected to outperform its state-owned counterpart on the ownership criterion alone. This can be illustrated by a shift in the public equilibrium from point P to a point lying further inside the production possibility curve, such as point P′. A conventional private monopoly will also experience organisational slack and labour inefficiency, but the effect thereof on the private equilibrium would be less pronounced, e.g. such as a move from point M to point M′.

Private monopolies furthermore have advantages over public enterprises in respect of dynamic efficiency. Because more is being spent on research and the development of cost-saving innovations, it could be argued that the production possibility curve would undergo an outward shift from TT to TT′, thereby changing the private equilibrium from point M′ to point M″. This shift could even be more pronounced in the case of the managerial firm where more surplus funds in the form of retained profits are available for research and development.

As discussed before, the rise of the managerial firm, which could also be a natural monopoly, brought along an improvement in allocative efficiency illustrated, e.g., by a movement along the production possibility curve, or, given dynamic productive efficiency, from point M'' to point MM. However, several factors contributed to an inevitable sacrifice in respect of productive efficiency, such as the separation of ownership and control, the high costs of gathering information, the large size and bureaucratic structure, the lack of monitoring by owners coupled with increasing managerial autonomy, and the availability of surplus funds. This reduction of productive efficiency could lead to a final private equilibrium at a point such as MM'.

While it is very difficult to estimate the relative importance of the different effects of ownership factors on allocative and productive efficiency respectively, the suggestion in this dissertation is that the final equilibrium of the modern managerial private firm or monopoly (at point MM'), would represent a higher level of social welfare than that of the publicly owned firm or monopoly (at point P').

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