### THE RATIONALE FOR PRIVATIZATION

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#### ÖZET

Özelleştirme en geniş anlamda, milli ekonomi içerisindeki faaliyetlerin kamu ekonomisinden piyasa ekonomisine transfer edilmesi anlamına gelmektedir. Özelleştirme uygulamasının çeşitli amaçları bulunmaktadır. Özelleştirme, mal ve hizmetlerin daha etkin, kaliteli ve ucuza sunabilmesine olanak sağlar. Özelleştirmenin bir diğer amacı mal ve hizmetlerin gerçek ve doğru maliyetlerini ortaya çıkarmaktır. Sermaye piyasasının geliştirilmesi, sınai mülkiyetin tabana yayılması, enjıasyonist baskıların azaltılması, devlete gelir sağlanması, gizli işsizliğin önlenmesi vb. amaçlar da önem arz etmektedir. Bu çalışmada yukarıda belirtilen özelleştirme amaçları incelenmektedir.

#### I. INTRODUCTION

Privatization encompasses the many ways in which the private sector assumes functions that were previously carried out by the government. These may range from the sale of public economic enterprises to contracts with private firms to deliver public goods and services. In each case, the functions are transferred from public sector to the private sector. This paper is interested in finding appropriate answers for the following questions: Why does the government sell its enterprises to the private sector? Why does it make arrangements with the private sector to produce and supply some goods and services? For what reason does the government break up its natural monopolies and deregulate them? It is possible to extend these questions. In sum, what are the main reasons of the privatization movement? In this paper, I shall try to make different explanations for the rationale of privatization.

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### II. THE OBJECTIVES OF PRIVATIZATION

## A. Greater Efficiency: A Review of Empirical Studies

Privatization fosters competition and thereby results in efficiency and effectiveness within sectors. Competition is very important to obtain more efficient and effective public services. Imperfect competition, for example, a monopolistic arrangement results in poor quality services.

Efficiency refers to the economically appropriate allocation of resources. The most efficient arrangement is the one that produces the greatest output per unit of input, for example, the lowest cost for a given level and quality of service (Savas, 1987; 122) Effectiveness, on the other hand refers to a situation in which output meets consumer's demands and gives them enough satisfaction. In other words, there should be no restrictions on consumer's choices. Consumers should not be forced to buy a certain product produced by a monopolist. In brief, consumers should be free to choose. Moreover, producers also should be free to decide what to produce, how and when. Both consumer and producer freedom, that is "economic freedom" can be achieved by privatization (Steel and Heald, 1982; 339-40) because; privatization brings efficiency and effectiveness.

Many emprical studies on the comparison of the private and public sector concerning the delivery of goods and services argue that public delivery of goods and services is less efficient than private delivery. Studies also show that public enterprises are not as efficient and effective as private enterprises. In the following I shall review the empricial literature on privatization.

Table: 1 summarizes the results of empricial studies concerning residential refuse collection. Most of the study carried out in the US argue that public supply of residental refuse collection results in much higher average costs than private supply.

An empirical study by Barbara Stephens found that the cost of the city provided (government provision) services is much higher than when the service is provided by private contractors. As Table: 2 shows, when cities do their own street cleaning, the cost is 43 percent higher than the cost for private contractors.

#### The Rational For Privatization

Table:1 Summary of Comparative Studies Of Public and Private Residental Refuse Collection

Author		Date		Number of cities surveyed	of cit	ber City Size ies zed	Means of data	Distinguished private and contract collection?	Distinguish collection a disposal co	and
Savas- Stevens	USA	197	5 1974	439	315	2500-720.000	visit, phone, mail	Yes	Yes	Cost of municipal collection is 29 % to 37 % higher than the price of contract collection in cities larger than 50.000 in population; no difference in effectiveness.
Kempe Quingley	Conneti	cut 197	6 1972 74	NR.	101	1101-158.000	mail, phone	Yes		"Cost of municipal collection is 14 % to 43 % higher than the price of contract collection
Kitchea	Canada	197	6 N.I	L 142(a)	48	Over 10.000	mail, phone	No '(b)	N.R.	"Municipally run refuse collection tends to be much more expensive." "Municipalities could economize by contracting-out"
Pommereh Fiey	Switzerl	and 197	7 1970	112	103	5000-423.000	Mail	No	NR	"Public production of refuse collection seems to be subject to higher average costs than private production."
Collins - Downes	St. Loui Country		7 N.I	3	33	Under 500- 65.000	Visit	Yes	Ya	"No clear pattern emerges."
Petrovoic- Jaffee	Midwe em USA	st 197	7 1974	140	63	25.000 180.000	Visit mail	Yes		"Costs tend to be less for a private firm under contract than a municipally operated system." Cost of municipal collection is 15 % higher than
Hamade- Aoki	Japan	198	1980	N.R.	211	N.R.	N.R.	Yes '(c)	Yes '(c) '	Municipal collection costs 124 percent more than contract collection.
Mc David	Camada	198	4 1982	NR	109	Over 10.000	Mail phone	Yes'(b)	Yes '(c)	Public collection appears to be 40 % to 50 % more cost than contract collection
Stevens	Los An- geles SCSA (		1983		20	10.000 200.000	Visit	Yes	Yes	Municipal collection costs 42 % more than contract collec- tion; no quality difference.

(c) While not stated explicitly, this appears to be the case.

(d) Standard Consolidated Statistical Area.

Source: Savas, 1987;126-27

Note: N.R.: Not. reported

(a) Kitchen reports only that he surveyed all cities over 10.000 in population. There were 142 such cities in 1970.

<sup>(</sup>b) Mc David reports that "nearly all private firms operate via contract". This may also apply to Kitchen's

This percentage is 73 for janitorial services and 96 for asphalt overplay construction. Altough, there was a significant reduction in the cost of service, Stephens found no difference in the quality of the service when provided by a private contractor. Stephens study was based on a survey which covered 121 cities in the Los Angeles Area.

Table: 2 Cost Saving Estimates From Contracting-Out (Based On 121 cities in the Los Angeles Area)

Service	Percentage Savings (Extra cost as a result of city provision *) %		
Street Cleaning	43		
Janitorial Services	73		
Refuse Collection	42		
Payroll Preparation			
Traffic Signal Maintenance	56		
Asphalt Overlay Construction	96		
Grass Maintenance	40		
Street Maintenance	37		

<sup>\*</sup> Those cost differences are adjusted in accordance with the differences in the scale of service, quality of service and physical conditions under which the service is provided.

Quoted in: Goodman, 1985; 119 / The original source: Barbara J. Stephens, "Comparing Public and Private Sector Productive Efficiency: An Analysis of Eight Activities"

National Productivity Review, Autumn, 1984, p.401.

Other studies also concluded that contracting- out results in cost savings. Table: 3 shows the cost savings estimates for such services ranging from street repair to the operation of local transit systems. Savings range from 25 to 94 percent.

#### The Rational For Privatization

Table: 3 Cost Savings Estimates From Contracting-Out in the USA( Studies Conducted since 1981)

Author of study	Type of services percentage sa	avings	
Ecodata, under contract with HUD *	Municipal street cleaning	43	
Ecodata, under contract with HUD	Municipal janitorial services	73	
Ecodata, under contract with HUD	Municipal tree trimming	37	
Ecodata, under contract with HUD	Overlay Construction	96	
Ecodata, under contract with HUD	Traffic light maintenance	56	
American Public Works Association	Wide range of municipal services	39	
U.S. Department of Transportation E.S. Savas Steve H. Hanke	Municipal collection of Urban Mass Transit Municipal refuse collection Municipal wastewater treatment	35-50 30 20-50	

<sup>\*</sup> HUD Department of Housing and Urban Development Source: Moore, 1987; 63.

Table: 4 compares the private and public firms in terms of the cost efficiency, service effectiveness and cost effectiveness of bus operations in New York city. The empirical study shows that the public buses had an operation cost per vehicle mile 32 percent greater than the private buses and a 12 per cent greater cost per passenger. Moreover, the private buses averaged 74 percent more vehicle miles per employee hour.

Table: 4 Comparison of Public and Private Bus Operations In New York, 1984

16 \$8. 3.17 \$62 8 2.2 .30	2.57
\$.17 \$62 2.2	2.57
\$.17 \$62 2.2	2.57
8 2.2	9
<b>41.</b>	97
	32 \$1

Source: Quoted in :Savas, 1987; 138(The original source New York State Department of Transportation, "1985 Report on Transit Operating Performance in New York State, "III-52.)

Another empirical study is given for child care services below. Table:5 shows that federally funded programs (grant and contract arrangements). Also for-profit child-care centers are less costly than the not-for profit ones. Savas notes that "federally funded programs are most costly because they have higher ratios of teachers and aides to children, employ more workers who do not provide care directly, pay higher wages, and offer additional services." (Savas, 1987; 209)

Table: 5 Monthly Cost Per Child For Day-Care Centers in the USA

Program Type	Cost \$
Federally funded Notfor-profit For-profit	188 120
Not federally funded Not-for-profit For-profit	118 102

Source: Savas, 1987;209. (The original source: Comptroller General of the United States, letter to U.S. Senate Committee on Finance, 25 September 1979.)

Another example is about a comparison of public education versus private education. As Table: 6 shows that per pupil costs are substantially higher in public schools than in private schools in America. Lott notes that, "About three-quarters of the private schools are church-affiliated, and services contributed by religious staff are valued at less than market value, thus lowering the cost figures for private schools. Yet, even relatively liberal assumptions of the implied subsidies do not significantly alter the case. If we assume that 11 percent of current expenses go to religious staff salaries and that religious teachers are paid one-half the rate of lay staff, public expenses are still at least 1.83 times greater than private costs." (Lott 1987; 476)

Table:6 Average Current Expenditures Per Pupil In Public and Private Schools in USA.

	Ехре	nditures pe	r pupil	Ratio:	Adjusted	Ratio:Public/
School Year	Average \$	Public \$ Private \$		Public/ Private	Private (\$)	Adjusted Private
1976-77	1.353	1.544	760	2.03	844	1.83
1977-78	1.512	1.736	819	2.12	909	1.91

Source: Lott, 1987;476

Another empirical study covering four different countries Colombia, Philipines, Tanzania and Thailand concluded that: "Preliminary calculations based on school expenditure data indicate that, on average, the unit costs for private schools is dramatically lower than that for public schools... This leads us to conclude that private schools are more efficient than public schools, at least for secondary level schools in the sample countries. " (Jimenez et. all. 1988; '9). The finding in those four countries concerning a cost comparison is shown in Table: 7)

Table: 7 Average Costs of Public and Private Schools in Colombia, Phillipines, Tanzania and Thailand

Country	Units	Averag	e Cost	Private cost/	
		Public	Private	Public cost	
Colombia	Pesos	18.281	12.674	69	
Philippines	Pesos	820	450	55	
Tanzania	Shillings	3.539	2.456	'69	
Thailand	Baht	4.492	1.762	39	

Source: Jimenez and et. all 1988; 11.

In light of empirical evidences, it is possible to say that the private delivery of goods and services is less costly and more efficient than public delivery.

# B. Revealing the True and Full Cost of the Service Provided

Privatization makes it possible to reveal the true and full cost of a service. It is a fact that publicly provided goods and services are underpriced because of some political and economic reasons. Political reason is that politicians tend to provide services below its true cost as to maximize their votes to get reelected. On the other hand, people would like to get services free of charge. They tend to resist paying for education, health and some other public goods. Therefore, the government usually produces goods and services below its full cost prices. In other words, public pricing of goods and services tends to be below the cost of production of these services.

Besides this simple notion, there are some economic reasons underpricing. First, current government accounting systems do not adequately assign the cost of capital to public enterprises. A private firm that must either borrow or

equity finance, its operation, includes both interest and depreciation as part of the cost it must recover with the fees it charges. These capital costs are rarely allocated to projects in the public sector. (Kent, 1987; 10)

Another economic reason is that the bureaucracy fails to determine the true demand of the individual, because of free rider problem. In a political market, there is no price signal. Consumers have to use the goods and services and accept its high monopolistic cost. There is no competitive price to be used as a benchmark. The easiest way for the bureaucrat to compensate for this lack of information about consumer demand is to charge a low fee while subsidizing the service from the revenues of general account budget. (Kent, 1987; 10-11)

## C.Promotion of Technological Advancement

Privatization fosters and initiates technological advancement. Because, competition as a result of privatization forces entrepreneurs to introduce new methods of production which will generate additional output with the same amount of inputs. In other words, tecnological progress results in greater output per unit of resource input and on the other hand, less human and physical capital per unit of output is required.

Technological advancement or progress encompasses invention and innovation. Invention is the process which is usually enhanced by the knowledge of engineering and scientific relationships. Innovations, on the other hand is the practical and effective adoption of a new product or process. (Gwartney and Stroup, 1980; 798). Both inventions and innovationss can be achieved by research and development investments. It has been argued that extensive regulation may reduce the pace of technological progress by hampering competition as an incentive for firms to discover new techniques or methods of production. It is alleged that monopoly firms designate less research and development expenditures compared to competitive firms. Nevertheless, empirical studies show that there is a positive relationship between indicators of invention and innovation such as expenditures on R&D or numbers of patents and degree of competition. Studies in the field of economics of innovation conclude that privatization policies-especially deregulatory measures are very important for technological progress. (see : Pera, 1989; 178vd)

### D. Development of Capital Markets

Another objective of privatization is to develop the capital markets. The main purpose for establishing a capital market is to withdraw some of the savings of individuals and private firms and to lead them toward productive investment fields. Privatization would play a crucial role in fostering an equity market.

However, it is a fact that developing countries have weak and underdeveloped capital markets. In these countries, there are few financial intermediaries to push savings into capital markets, limited numbers of institutional investors such as pension funds and insurance conpanies and little equity to offer. In brief, circulation volume of shares and bonds are inadequate in the stock markets of the developing countries. Government may play a significant role in those countries to utilize and develop the capital market through share offerings to the public. Shares of the public economic enterprises can be solved in a domestic capital market. Potential buyers would be employees of the public enterprise subject to denationalization. Individuals, private firms and foreigners constitute other potential buyers. By selling some equities to foreigners capital inflows from abroad take place and this can supplement domestic capital formation. (Aylen, 1987; 23-25)

# E. Broadening the Wealth and Achieving Widespread Private Ownership In Society

Privitization can broaden the wealth and achieve widespread private ownership in society. This objective may be attained by selling ownership rights to the public and employees of public enterprises subject to denationalization instead of to a private firm or conglomorate. Optimal distribution of shares as an important question arises during the sales process. The distributional question is: " to whom should the shares of public economic enterprises be sold?"

Offering shares to the employees not only results in gain by employees, but for the firm as well. Because an employee who holds a share of the firm for which he works, is expected to work hard and consequently this results in productive efficiency. This idea is commonly known as ESOP (Employee Stock Ownership Plan) in the literature. ESOP as a means by which employees

can own stock in the companies where they work. (Blasi; 988; xi.)

The idea of ESOP was first developed by Louis Kelso, an investment banker, corporate and financial lawyer. He was the publisher of a profitable suburban newspaper chain in Palo Alto, California. He had promised his emloyees that when he was ready to retire they would have first chance to buy the business before it was offered to outsiders. When that day came, lawyers and bankers were summoned to work out the means by which the employees could buy out the three major stocholders. In due course, the experts announced their findings. If the employees would commit themselves to maximium payroll deductions, pull their total savings, borrow as much as possible, mortgage or second mortgage their homes, and cut their living standards to the bone, they could just manage to pay the interest on the loan. They would never be able to repay the principle. There was simply no way for the employees to become newspaper owners. At this point, Kelso tried to implement his Employee Stock Ownership Plan (ESOP). Through it, the newspaper employee were able to buy 72 percent of the stock without touching a penny of their paychecks or savings. (The remaining 28 percent was purchased outside of the ESOP by certain employees, who paid for it out of their personal assets.) Both the ESOP's loans and interest were paid off almost twice as fast as originally scheduled- in eight and one-half years instead of fifteen. Senator Russell Long, who spent great effort establishing ESOP laws in the U.S. congress noted the benefits of the ESOP plan as follows: " each worker will be put in a position where his efforts towards cost minimization and increased production will directly influence the value of the capital estate which he aquires during his working life time. I would anticipate that strikes and slowndowns, antiquated work rules, feather bedding, resistance to automation and unreasonable wage demands- all seemingly insoluble problems up to now will eventually disappear as workers come to realize how these activities not only work against the interests of consumers as a hole but against their own individual interests." (Blasi 1988; 24)

In more general perspective, it can be said that ESOP may achieve the following objectives:

- It can broaden the wealth,
- It can increase the capiltal formation,

- It can promote labor-management cooperation,
- It can improve economic performance and competitiveness

## F. Curbing Inflation

Privatization can be considered a disinflationary tool. In many countries public economic enterprises are seen as one of the important factors causing cost-push inflation. It is a fact that public economic enterprises do not work efficiently and effectively and they are usually in need of supplementary funds from general account budget. It is alleged that privatization eliminates the financial burden of public economic enterprises on the Central Bank and Treasury.

## G. Raising Extra-Revenues for the Government

One of the objective of privatization would be to raise revenues for the government. This strategy would be important when the government encounters a financial crises. The government obtains revenues from numerous sources and those can be classified into two groups; domestic revenues and external revenues. Taxes are the main source of government revenues. However taxable capacity and taxation limits restrict the government to use this instrument as it wishes. In addition to taxes the government collects user charges, borrows money from individuals by selling treasury bonds etc. or issues money through the central bank which is ultimately inflationary.

Foreign economic aids and borrowing money from international financial institutions (such as, IMF, IBRD etc.) and foreign direct investments in home country are same examples of external sources of government revenues. As mentioned there is a limit to raise the taxes and to borrow money from both domestic and foreign sources. Privatization would be an important policy for the government to raise money. The government may put forward the following policies:

- 1. Publicly owned lands could be privatized.
- 2. Some assets or shares of PEEs could be sold individuals or private firms (Denationalization)

3. Some types of public goods could be provided in return for a fee (Imposing user charges)

# H. Eliminating Hidden Unemployment and Reducing The Power of Public Employee Unions

Publi sector unions are strongly opposed to privatization. They argue that privatization is an anti-labor movement and it destroys jobs. But as noted by Pooles; "if five workers are being paid to do what three workers can do, it is not "antilabor to stop this waste. It is protaxpayer and pro-consumer. But it is also pro-labor in the sense that everyone's long term intersts, including that of labor union members is best served by a sound, healthy economy. "(Poole 1983; 115)

It is fact that hidden unemployment is one of the most important problems of public economic enterprises and of other public institutions which performs a variety of tasks. By privatization, this cost can be eliminated. Moreover, privatization reduces the power of the public employee unions, which is usually the main reason for price hikes. (Bennett and Dilorenso, 1983) E. Savas argues that privatization can reduce the power of the public employee unions. He claims that "Public sectors employee unions give endorsments, make campaign contributions, and supply campaign workers to favored candidates for office and are quite explicit about their expectations when their candidates elected: they expect and frequently obtain - a quod pro quo in the form of greater expenditures for services their union produces, pay raises, and collective bargaining rules that will lead to more agency shops, the net effect being to enlarge the union treasury and thereby increase the salaries and perquisities of the union leaders. While technically such behavior may be legal, in essence it differs from the bribe paid by a private firm to secure a contact." (Savas, 1982: 84)

#### SUMMARY

### THE RATIONALE FOR PRIVATIZATION

Privatization, in braod meaning, efers to transfering the role and functions of the government to the private sector. There are several objectives of privatization. One of the most important objective is to achieve greater efficiency and effectiveness. Privatization also makes it possible to reveal the true and full cost of a service. Another objective of privatization is to develop capital markets. Broadening the wealth and achieving widespread private ownership in society is another objective. Curbing inflation, raising extra-revenues for the government, eliminating hidden unemployment and reducing the power of public employee unions are also considered as the objectives of privatization. This paper aims to analyze these objectives of privatization in detail.

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