



Public and Private Enterprises: Finding the Right Mix

During the 20th century the economic importance of the state grew all over the world. In **developed countries** central government spending accounted for less than 10 percent of **gross domestic product (GDP)** in the early 1900s, but by the 1990s that share had grown to nearly 50 percent in many of those countries (Figure 11.1; Data Table 3). Among the major historical factors contributing to this government expansion were the Russian Revolution of 1917 and the Great Depression of the 1930s. But the data suggest that this expansion continues even today: over the past 35 years the share of government spending in the GDP of developed countries roughly doubled.

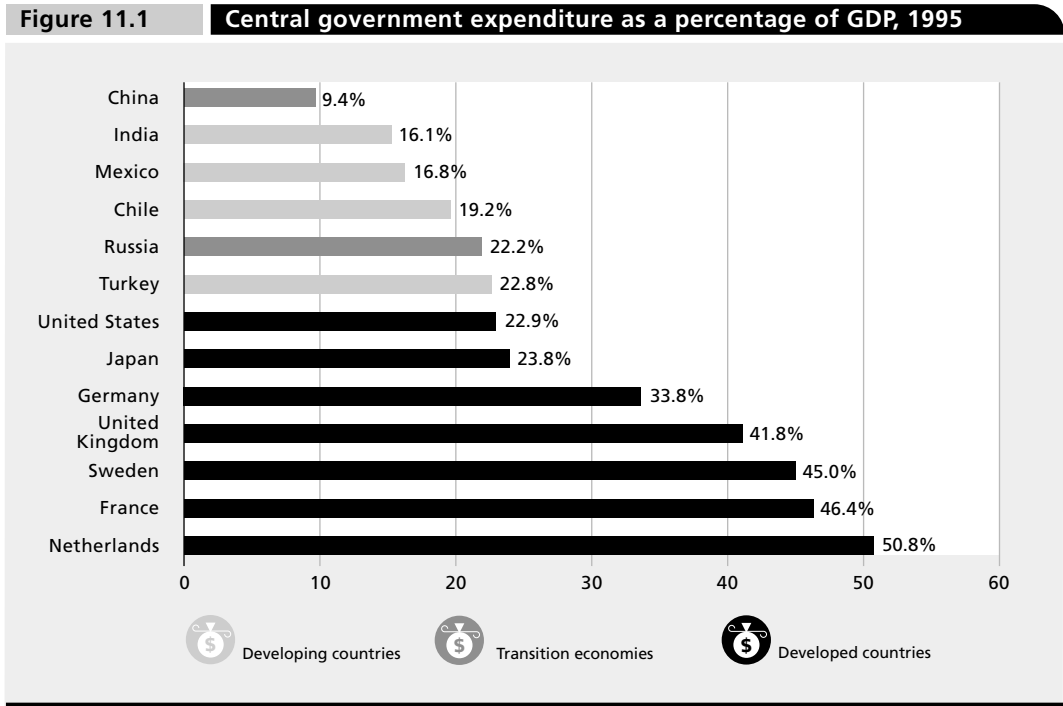
In **developing countries** the economic role of government grew dramatically in the second half of the 20th century, after the end of colonialism and in pursuit of such development goals as **industrialization** and social equity. In many of these countries the state was striving to mobilize resources and direct them toward rapid **economic growth**, rather than just to stabilize the economy, as in most developed countries. Until the 1980s the pattern of state-dominated development—which included centralized planning and state control of the economy—was widely followed. Still,

the share of government spending in the GDP of developing countries is less than half that in developed countries (see Figure 11.1 and Data Table 3). Does this mean that a growing share of government spending in GDP should be seen as a sign of development?

The Dilemma of Public-Private Ownership

Government budgets in developing countries are not only proportionately smaller, but they are also structured differently. In developed countries more than half of government spending is devoted to social services, including pensions, unemployment insurance, social security, and other **transfer payments**. In developing countries much less government spending goes for social services and much more is used to subsidize commercial (that is, selling goods and services) state-owned enterprises. Unlike other state-owned enterprises that provide free public services (for example, schools and health clinics), these state-owned enterprises could also be run for profit by private firms. Governments, however, sometimes prefer to keep them under their direct control. The share of commercial state enterprises in GDP and

Is a growing share of government spending a reliable indicator of development?



in **gross domestic investment** tends to be higher in poorer countries (Figure 11.2).

- Only government ownership of the biggest enterprises can help avoid mass unemployment.

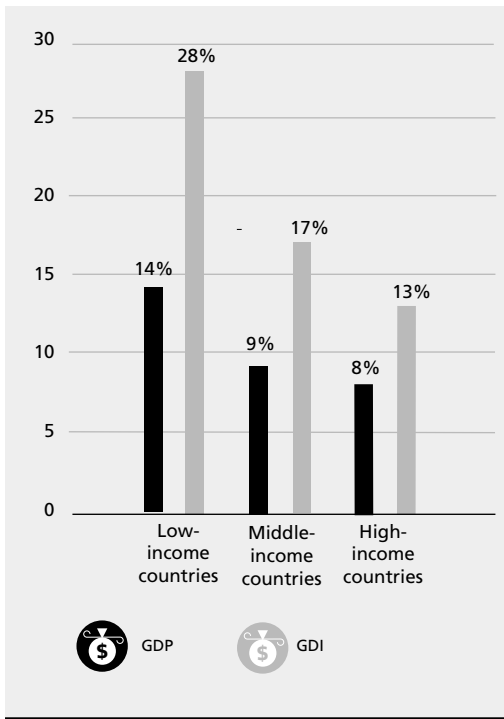
Is a high share of state enterprises a problem? Is it good or bad for the **economic growth** and development of developing countries? Those who want to preserve extensive state enterprises argue that:

- Only government is capable of providing sufficient investment for technical modernization of major national industries.
- Only direct government control over certain enterprises can prevent socially unacceptable high prices for basic goods and services such as energy, housing, and transportation.

On the other hand, experience from many countries shows that state enterprises are normally less **efficient** than private firms. One of the main reasons is that state enterprise managers have little or no incentive to pursue profitability for their enterprises. Easy access to government subsidies and government-guaranteed loans effectively remove the threat of bankruptcy as a check on inefficiency. Besides, it is often hard to run state enterprises at a profit because governments tend to keep state enterprises' selling prices artificially low, and because rules often do not allow these enterprises to lay off excess employees.

Figure 11.2

State-owned enterprises' share of GDP and gross domestic investment (GDI), 1986–91



In countries where the share of state enterprises is high, their typically low efficiency can hinder economic growth. In addition, governments have to cover the financial losses of these inefficient enterprises. To meet the resulting budget deficits, governments often have to either print more money and thus cause inflation, or borrow and build up their domestic or foreign debt. In both cases national economies are destabilized and growth opportunities are lost.

Given all that, is it ever preferable to keep enterprises under government ownership? What is the ideal size and com-

position of a country's public sector? And can there be any general answers to these questions independent of ideological beliefs?

In fact, it is increasingly recognized that state intervention is justified only where markets fail. There are five basic situations, called **market failures**, where the private sector tends to underproduce or overproduce certain goods and services:

- Underproduction of **public goods** such as defense, law and order, roads, and environmental protection.
- Underproduction of goods and services with positive **externalities** (for example, public health and education) and overproduction of goods and services with negative externalities (for example, cigarettes).
- Overpricing and underproduction by **natural monopolies**, for example by electric and water utilities.
- Insufficient supply of social services such as pensions or medical and unemployment insurance.
- Insufficient information available to some parties affected by market processes (for example, information about the quality of food products and medicines available to consumers whose health is at risk).

These five situations call for some kind of government intervention. But even where markets clearly fail, government provision

When should governments intervene in economic activities?

of undersupplied goods and services is not necessarily the best option. We have already discussed the reasons for the typically low efficiency of state enterprise management. Add to that the possibility of corruption among bureaucrats and you get what came to be called “government failure”. Increased awareness of this problem explains why some governments of developed countries are searching for alternatives to state ownership, such as new methods of regulation or government funding for private provision of public goods. A notable example of such an alternative solution to both market and government failures is provided by the new phenomenon of public funding for private prisons in the United States.¹

Is There a Trend toward Privatization?

By privatizing all the enterprises that can be successfully run by private firms, governments can often make national economies more efficient, on the one hand, and free their budgets from the burden of subsidizing loss-making enterprises, on the other. As a result they are able to focus on tasks that cannot be handed over to markets, such as building **human capital** and providing for human development (see chapter 1). For example, according to some estimates, shifting budget funds from state enterprise subsidies to public health care would have allowed central governments

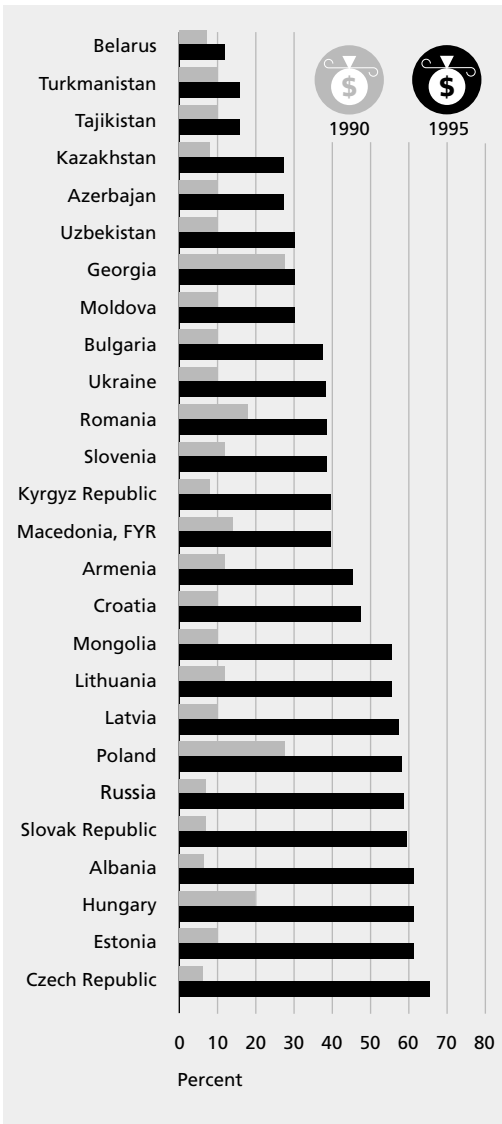
to increase their health spending by about four times in Mexico and five times in India. Alternatively, Mexico’s central government could have increased its education spending by 50 percent, and India’s by 550 percent.

If governments are to shift away from supplying marketable goods and services, there must be active private sectors that are ready to take up these activities. In some cases reducing the economic prominence of state enterprises is even possible without extensive privatization, mainly by means of **market liberalization** that leads to accelerated growth of the private sector. That was the case in the Republic of Korea in the 1970s and 1980s, and in China in the 1980s and 1990s. But more often, particularly where public sectors are much larger than private sectors and so absorb a lot of scarce national resources, special privatization programs are needed.

Since the 1980s many developing and some developed countries have adopted privatization programs. You can attempt to judge their scale by examining data on government proceeds from privatization in Data Table 3. Note that these data depend not only on the scale of privatization but also on its methods. Selling state enterprises to outside owners normally brings more revenue than selling them to enterprise managers and employees, while voucher privatization (such as in Russia in 1991–93) brings no revenue at all.

Figure 11.3

**Private sector output
as a share of GDP,
1990 and 1995**



The most impressive privatization process is currently under way in former socialist countries. Their transition to market-oriented economies requires unprecedented mass privatization of formerly dominant state enterprises. For

the different starting points and speeds of privatization in this group of countries, see Figure 11.3. Among other regions of the developing world, privatization programs have accelerated in Latin America and Southeast Asia, while in Sub-Saharan Africa the process is less pronounced.

Unfortunately, in some transition countries—particularly those suffering from transitional economic crises—market reforms have resulted in neglect of the state’s vital functions, such as law and order or critical social services. Important programs in education and health, for instance, have been cut along with or even instead of cutting subsidies to money-losing enterprises. Such policies not only damage people’s welfare, they also erode the foundations of further national development.

Many experts argue that, although state-dominated development has failed, so would “stateless” development. Think about it: why are an effective state and viable private sector both important for development?

Note

1. Prisons were traditionally state-owned “enterprises” because they “produce” such public goods as obedience to the law and public safety.