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EFFICIENCY OF THE PUBLIC SECTOR*

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Taking into account the purpose of the Conference, a standard textbook presentation of the subject does not appear very useful. Besides, there is no such thing as one, single, universally established public sector. In different countries, different types of public sectors are to be found. Since our subject is efficiency, we are, clearly, interested not just in the public sector per se, but in the most efficient public sector. An inefficient public sector cannot generate efficient expenditures. In other words, the proper subject of this paper is an exploration in the comparative efficiency of various possible institutions of the public sector. For obvious reasons, I cannot go beyond a general survey of the problem.

WHY IS THE PUBLIC SECTOR EXPANDING?

It is well known that the share of the public sector is increasing in all countries. It is not uncommon that one-half of the manufacturing industry is owned by the state or that the state controls one-half of the total investment expenditures or that *public* expenditures amount to one-half of GNP.***

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*** The following data may provide an illustration. They refer to the share of the public sector in total manufacturing value added in precentages:

Turkey 1972	47.3	Egypt 1981/82	66.7
Zambia 1975	51.0	Bangladesh 1977/78	70.6
Syria 1977	57.6	Algeria 1978	74.9
Sri Lanka 1976	64.3	Pakistan 1975	84.0

Source: UNIDO Secretariat, "Changing Role and Function of the Public Industrial Sector in Developing Countries", 10/81. In Venezuela in recent years the public sector participated: in savings 56%, in investment and manufacturing 70%, in exports more than 90%. The public sector is absolutely dominant in East European and East Asian countries.

The reasons for the rapid growth of the state sector are varied and may be classified as follows:

1) Provision of services to the public. Education, health care, social insurance, unemployment benefits and welfare programmes are now considered to be the state's responsibility.

2) For reasons of national security, many states established government-operated military industries such as arsenals, naval shipyards, aircraft factories, etc., a long time ago. The production of tanks, rockets and other sophisticated weaponry has been added in more recent times.

3) Since medieval times in Europe and elsewhere, minerals have been considered the property of the sovereign. Thus royalties — the name indicates the origin — and often the mines belong to the state.

4) One of the consequences of various agrarian reforms is that the state establishes itself as a major landowner. Large government-operated estates are supposed to breed highly productive cattle, to introduce new varieties of seeds and to spread modern agricultural technology.

5) Adequate infrastructure is a precondition for successful industrialization. Infrastructure is highly capital intensive and requires huge amounts of capital usually not available to the private sector in the less-developed countries. Thus, the state undertakes to build and operate roads, railways, irrigation projects, power stations and (usually at the municipal level) utilities. Post office, telecommunications and national airlines are also often state-owned. In more recent times, highly expensive research facilities may be included in the infrastructure group.

6) In order to raise revenue without taxes, the state appropriates exceptionally profitable industries, turning these into state monopolies. In earlier times such industries included production of tobacco, matches and salt; a representative of the modern monopoly is the petroleum industry.

7) In order to salvage them from disintegration and bankruptcy, the state often nationalizes old inefficient industries — such as coal and steel in Britain — considered important for the national economy.

8) Since the advent of Keynesianism in the late 1930s, states have been experimenting with fiscal policies. That meant increasing public expenditures in order to build up or maintain aggregate demand. Keynesian fiscal policy in general, and military expenditures in particular, increased the share of public expenditures in GNP.

9) Finally, public ownership has traditionally been identified with state ownership. For this reason many socialist parties and countries that call themselves socialist insist on the nationalization of the entire economy or, at least, of its greater part. In such countries the state budget represents the greater part of the gross national product. It may be shown that socialization and statization are not identical; in fact, they have nothing in common. Thus, social property, which is characteristic of socialism, implies the elimination of state control and the establishment of self-management. I add this comment in order to avoid possible confusion. But this type of institutionalization is not the subject of the present paper.

The preceding discussion indicates that the repertoire of public expenditures and state interventions is rather rich and is expanding every day. It is not therefore the public expenditures as such, but the adequate organization of the public sector that is of paramount importance. There is no longer a choice: private or public sector. The public sector is with us and its importance in the modern economy is increasing. For this reason it requires systematic — not casual or *ad hoc* — treatment.

Before we proceed, I should like to simplify my task somewhat. I do not intend to deal with the public services. All I wish to say about point 1 is that, on the benefit side, substantial expenditures in this sector have a counter-cyclical effect (and, of course, they are socially desirable), while on the cost side they have a depressive effect on efficiency because they increase the burden of taxes. Neither do I intend to discuss various Keynesian recipes of budget deficits. For less developed countries they are hardly relevant. Nor shall I discuss the problems of socialist economies. An interested reader will find extensive information on that in my book on the subject.* Thus, points 8 and 9 are out as well. We are left with 2—7 and with the problem of adequate institutionalization of the public sector.

TYPES OF ORGANIZATIONS AND CONSEQUENCES

If socialist organization is excluded, there are three organizational types that we may consider.

1) State-owned industries run as government departments. The Post Office is a case in point. This is the oldest organizational form and is also the prototype for the centrally-planned economies.

2) The public corporation, which was invented by the British Labour Party in the 1930s. As the name suggests, it is a hybrid form. As a corporation it is exposed to the market, must cover costs and (in principle) earn profits. Being public, profits go to the Treasury, and a general manager is appointed by the government.

3) The participatory corporation. This operates on the market like any other corporation. Its ties with the government are looser and, therefore, its financial responsibility is greater. Managers are appointed by a joint committee including representatives of the government and of the corporation. Workers and employees participate in management as practiced in Europe under various co-determination schemes based on parity in the boards of directors.

It if often argued that state-owned firms are rarely profitable, that they drain state budgets instead of providing them with money, that they are less efficient than private firms. The cost side is further expanded by pointing out that such firms are highly politicized: managers are chosen on the basis of political affiliation, not professional capability, and the same applies all the way down the hierarchy, including the hiring of unskilled workers. Where professional expertise

* B. Horvat, *Political Economy of Socialism*, Sharpe, New York, 1982.

is replaced by political favours and business results do not matter, a fertile ground for corruption is created. State industries do not observe financial discipline: loans taken are repaid late or not at all. Before elections or for other political reasons, inapt governments are inclined to freeze prices, which is most easily accomplished with government industries. As a result, corporations lose ability to react to market stimuli and tend to behave like government bureaucracies with little or no business responsibility. In short, state enterprise is said to be unprofitable, inefficient, and politicized. There is little that can be said for the benefit side.

There is much truth in the allegations quoted. One ought to realize, however, that the objections apply not to the state enterprise as such, but to the one run as a government department. Turkish state industry is perhaps a good example of that genus. That is why departmental organizations have been replaced by public corporations. The French state automobile firm of Renault, to quote an example, is as competitive, innovative or profitable as any private firm.

Yet, public corporations have their own problems. If they are organized as state monopolies, i.e., if entire industries are run as single firms, efficiency and competitiveness tend to be lost. The idea, the bigger — the better, does not seem justified by experience. Besides, such industrial mastodonts easily encounter serious labour problems. The current many-month long strike of British coal miners is a case in point.

The modern management solution to labour problems is participatory management. It eliminates strikes and increases efficiency.* It may be particularly efficient in the public sector incurbing corruption and preventing political appointments. In countries with well developed unions, the government and the unions will jointly appoint managers and set up internal participatory bodies. Where unions are weak, this can be done at individual firm level.

The other organizational component is as great exposure as possible to market forces. That implies business autonomy and several or many firms in an industry. Financial independence of individual firms does not mean absence of co-ordination. Co-ordination is exemplified in setting up joint R&D establishments, forming export associations, etc.

A participatory corporation is likely to be more efficient than a private firm. Since management-labour conflict is to a large extent eliminated, latent and overt social warfare is replaced by co-operation. Since workers' wages depend on the success of the firm, workers will see to it that the costs are reduced and the firm is properly managed. The latter implies that incompetent managers will soon be fired. If the public sector is properly organized, poor ma-

* The two European countries with the most developed co-determination — Sweden and Germany — are also the countries with the smallest number of work days lost due to strikes. And the efficiency of these countries hardly needs comment.

nagers are much more easily replaced than in a private firm where this is to a great extent a chance affair.*

THE ORGANIZATION OF THE PUBLIC SECTOR

Leaving aside social services, four different segments of the public sector may be distinguished:

1) Natural monopolies such as transportation and telecommunication systems. Although exposed to the market, they cannot be left entirely to market forces. They need very specific regulation. On the other hand, even the Post Office need *not* be run like a government department.

2) The bulk of the public sector will consist of large participatory corporations, fully or partially publicly owned, competing in the market with private concerns and enjoying financial autonomy. The latter implies that they are profitmaking firms, that business decisions are made without asking the government for permission, but that they are obliged — and this makes them different from private firms — to keep the value of invested capital intact, whatever the sources of investment. If the firm suffers large or prolonged losses, the business autonomy is suspended, the firm is reorganized and incompetent managers fired.

3) It seems desirable to include co-operatives in the public sector since they are organizationally similar to the firms in section 2. Producer co-operatives in manufacturing, agriculture, fishing, trade, construction and transportation are small participatory corporations owned by their workers. American ESOP (Employee Stock Ownership Plan) firms and other similar schemes may also be included in this category.

4) Experience has shown that public firms and private banks do not work well together. The two systems are simply not compatible with each other. And since we wish to sever the links with the Treasury — as a precondition for market competitiveness — the banks ought to be made public as well. That is what France has done. Vigorous industrialization and an aggressive export orientation — the two preconditions for fast growth — also require the socialization of banks in order to prevent destabilizing financial speculation and the flight of capital. Some of the public banks ought to specialize in financing co-operatives (of artisans, farmers, etc.). And, of course, small co-operative banks ought to be encouraged as well.

If the efficiency potential of the market is to be fully exploited, we still need an institution to make the public sector a smoothly working system. The institution required is a Development Fund which is interpolated between the Ministry of Finance and the market. The National Development Fund is the counterpart of the Na-

* A good illustration is the American Chrysler Corporation. When the firm was heading toward bankruptcy, its managers were primarily concerned with inventing lavish pension schemes for themselves. The firm survived in spite of its managers, and they were fired only afterwards.

tional Bank and so it may be useful to describe briefly the functions of the two institutions.

The National Bank must supply the economy with adequate amounts of domestic and foreign money. It serves as a lender of last resort and so saves the monetary system from periodic breakdowns. In controlling the money supply, the National Bank also exerts important influence on general economic stability. The control of prices is perhaps the most important task in this respect. Yet control of the money supply must be strictly qualified. The quantity theory of money explained inflation as due to an oversupply of money. Keynes's inflationary gap was not far from this interpretation. And such an explanation is not untrue. Thus, monetary restriction appeared as an obvious remedy. When applied, however, it usually produced contraction of economic activities and unemployment. It was then discovered that inflation can also be generated by structural disproportions, and that monetary policy is powerless to cope with such inflation. The third type of inflation is caused by disproportions in income distribution. This is usually discussed under the heading of cost-push inflation, together with some less important forms. It is clear that monetary policy cannot handle this case either.

An analogy may aid in understanding the function of the National Bank. A car engine cannot run without oil. Similarly, business transactions cannot be performed without money. If the supply of oil is inadequate, the engine may suffer damage and may even break down. Thus, pumping oil into the engine is of vital importance. But if the engine does not run properly, no amount of oil will eliminate the trouble. The engine itself must be repaired. The damage the National Bank can cause by pursuing incorrect policies is much greater than the help it can provide in overcoming difficulties by correct policies. It is an institution of marginal and short-term adjustments.

In addition to prices, the Bank can also try to control investment (and aggregate demand) by manipulating discount interest rates. Empirical studies, however, have shown that investment demand is highly inelastic to interest rate changes. What matters is not the rate of interest but profitable investment opportunities (in industrialized countries) or the availability of investment money with reasonable rates for borrowers (in developing countries).

While the Bank alone may not be terribly efficient, in conjunction with a Development Fund it can produce miraculous results. The Fund supplements the monetary operations of the Bank by stabilizing investment, aggregate demand, balance of payments, and those prices whose changes are due to structural disproportions. In the long run, the Fund is responsible for achieving the desired rate of growth.

The Fund's activities replace fiscal policy, which has traditionally been conducted by the Ministry of Finance. This policy is generally so closely tied up with budget policy that theoretical analysis fails to separate the two. Yet the distinction is quite clear. A budget is a device by which the planned activities of government administration and various public services are financed from planned sources.

Stabilization, development, and income redistribution activities are extra-budgetary and belong to the fiscal policy sphere. The first

two can be handled by the Fund, while the last falls exclusively within the province of the Parliament.

If the Development Fund is established as a separate investment authority, certain conditions must be fulfilled. The Fund cannot invent new taxes or change tax progression and, in general ,cannot affect income distribution among social groups or segments of the economy, But it can manipulate surtaxes so as to equilibriate aggregate demand and supply. The Fund operates within the confines of the social welfare function defined by the Parliament. It is responsible for stability and growth under conditions of Pareto-type efficiency. Increasing efficiency without disturbing distribution — this is the goal.

Theoretically, this goal is not completely unambiguous, and in practice deviations cannot be avoided. But the situation is not substantially different from that in the monetary field, where the National Bank has come to be universally accepted as an independent monetary authority.

There are four sets of objectives the Fund can fulfil: implementation of investment programmes, short-term investment in working capital for special purposes, operating subsidy schemes and compensations, influence of aggregate demand and supply (by surplus absorption and deficit spending, replacing former budget surpluses and deficits). Investment finance comes from the repayment of loans, earmarked taxes, and various kinds of borrowing.

In organizational terms, the Fund is a policy-making, not a business institution, a financial and not an administrative one. The actual administration of loans is left to commercial banks, and the actual administration of taxes to the Ministry of Finance. Short-term economic policy requires close co-operation among the three institutions. While the Ministry is preparing the budget, the Fund formulates its annual intervention programme and the Bank prepares financial flow forecasts. The administrative budget, investment intervention programme (including subsidies), and financial flows forecasts represent three components of an annual development plan. The annual plans represent operational breakdowns of a medium-term development plan prepared by the Planning Bureau of the government.

If participatory corporations have business autonomy, is it not likely that they might misuse it to the detriment of public interests? Should not government, after all, impose a stricter administrative control? It is true that management cannot act in secret any longer since participatory bodies imply workers' control. And secrets known to many cannot remain secrets. Yet in a participatory firm, management and workers have such strong common interests that a collusive action is still possible. Efficient control is, of course, desirable. But not an administrative control which stifles initiative. The problem is solved by setting up a Social Accounting Service as practiced in Yugoslavia. Whatever a firm does results eventually in a recorded financial transaction. Any financial change is recorded in the computer system of the SAS which conducts its own very simplified bookkeeping for every firm. The SAS performs three different roles. It is a public auditing agency performing financial control all the time

and not only once or twice annually.* It is an advisory agency to which any accountant or financial manager may turn to at any time for clarification and advice. It is, lastly, a statistical agency producing the financial flows accounts for the economy. By the end of the first week in the month, the SAS has 20 leading indicators for the past month ready for the government. Quarterly it produces about 200 indicators for every firm. Thus, the entire nation may supervise its public corporations.

Finally, research and development has become so important for the modern economy that it cannot be left to the market or to the vagaries of private concerns. It must be treated as an important segment of the public sector. But the institutionalization of research is a complex problem which requires a special study and cannot be treated here.

CONCLUSION

If the public sector is to function efficiently, its firms must operate in the competitive market and administrative meddling with their affairs must be prevented. On the other hand, the government must have full control of the levers of economic policy. The National Bank is used for short-term adjustments, the National Development Fund for achieving long-term equilibrium. The latter implies the elimination of structural equilibria and a sufficiently fast growth to preserve full employment. The Social Accounting Service is an instrument of financial control and a source of statistical information.

Currently many countries experience large balance of payments deficits. One of the most frequent fallacies found in the development literature is the explanation of such deficits by saving gaps. The country lacks investment resources, so it is argued, and the gap is bridged by import surplus. The argument confuses social accounting identities with causal explanation. And the usual recommendation — increase private profits in order to increase saving, in order to expand investment, in order to generate growth — proves disastrous. Private profits increase but none of the desired consequences follow. Instead, income distribution gets extremely skewed, social polarization increases, labour relations worsen, political tensions mount, and social conflicts become explosive.

Due to limited investment absorption capacity an economy cannot increase the share of productive investment by more than 1—2 percentage points annually. If the share of gross investment in GNP this year is, say, 17 per cent, next year it may be increased to 18—19 per cent, but not more. Any reasonably organized economy can generate additional 1—2 per cent saving annually and that will support a stable rate of growth of investment of an order of 15 per cent per year. If foreign trade is not balanced and foreign exchange gaps persist, this

* A case was recorded in Yugoslavia where the SAS stopped a state government from paying salaries to its employees because the payments did not comply with federal regulations.

is due to a wrong monetary policy and structural disequilibri, not to the saving gap. The saving gap is an accounting reflection of the same causes.

Within the framework described in this paper, a strong public sector is likely to become a powerful growth locomotive. Large public corporations will provide markets for swarms of small private and co-operative firms acting as co-operating suppliers. Individual farmers will co-operate with public agricultural estates. Co-operative banks will provide funds for starting numerous new businesses. The National Development Fund will make possible an accumulation of capital sufficiently large for various infrastructural projects. It will also be able to intervene whenever structural imbalances appear. A public sector, built not as an aggregate of fortuitous assembled elements but as an interdependent system, will provide a basis for an efficacious development policy. If that is achieved, public expenditures will also be efficient.

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