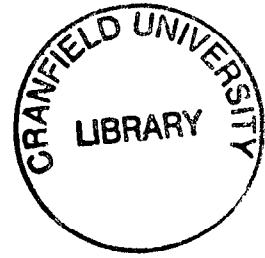




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**SWP 10/90 THE IMPORTANCE OF OWNERSHIP**

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## THE IMPORTANCE OF OWNERSHIP

Until recently, most mainstream economists tended to argue that ownership was relatively unimportant. For instance, Shonfield in his study of *Modern Capitalism*(1965) wrote:

'The most important discovery of the post-war period is that ownership is of itself much less important than either revolutionary proletarian or conservative bourgeois philosophy alleged' (p.378).

Economists were in general more concerned with market structures and the importance of competition in efficient resource allocation than with worrying about who owned what. However, with growing interest in free market economics, in the last few years ownership has become a subject for study in its own right. The present Conservative Government clearly believes that changing ownership from the public to the private sector will bring about a major improvement in economic efficiency. This view has spread to other countries, notably the USA, France and Japan, where chunks of their public sectors are being privatised (Hemming and Mansoor, 1988).

It is therefore worth reviewing why ownership might be important. What are the economic forces which could cause public enterprises to be less efficient than private enterprise? Efficient in the sense of supplying

any given output at least cost, what economists sometimes refer to as *production efficiency*. The other broad type of efficiency with which economists are concerned is *allocative efficiency* - allocating resources in society so as to maximise social wellbeing - but this has featured much less prominently in the privatisation debate.

### The firm as a 'black box'

The traditional approach to the firm is to treat it as a 'black box', which absorbs inputs and produces outputs. It is this approach to the firm which dominates in most economics textbooks. The firm is essentially a converter of inputs into outputs in a mechanical and pre-determined fashion, with profit maximisation included as an assumption. This assumption alongside given technical relationships between inputs and outputs (the production function) means that the precise quantity of outputs produced is given. In particular there is no scope for managerial discretion. Moreover, the neoclassical economic models of competition and monopoly assume full production efficiency so that firms always choose the least cost combination of factors of production - land, labour and capital - to produce any given output. Instead of being concerned with how to achieve production efficiency, such theories concentrate upon the achievement of allocative efficiency, with prices related to marginal costs of supply as a necessary condition.

Economists in the post-war period have expended much time and energy upon refining this argument to develop welfare maximising conditions

given varying 'second best' scenarios; and this stylised debate split over into the literature on public enterprises which became dominated by the search for 'optimal' pricing and investment rules. Consequently, the 1967 White Paper, (*Nationalised Industries: A Review of Economic and Financial Objectives* (Cmd. 3437) endorsed marginal cost pricing and a 'test discount rate' based upon the 'social opportunity cost of capital' for public sector investments. However, such rules can only guarantee a welfare improvement if there is full production efficiency and production efficiency cannot be safely assumed, especially in the public sector.

Only from the early 1970s did much attention begin to focus upon the actual behaviour and performance of publicly owned firms. This new interest was associated with a more general interest in economics in investigating the actual operation of firms. The various theories spawned are now usually referred to in economics as 'alternative' or 'managerial' theories, to distinguish them from the traditional, neoclassical models of competition and monopoly. In these 'alternative' theories there is no presumption, as exists in the traditional theories, that firms maximise efficiency and pursue only profit. Indeed, it is recognised that 'firms', per se do nothing at all. Only individuals within firms make decisions, set objectives and pursue them. The managerial theories therefore shifted the focus of economic enquiry to the internal organisation of firms and, more specifically, to the behaviour and performance of management.

## The separation of ownership and control

We can trace the origins of 'managerial' theories of the firm to the pioneering work of Berle and Means (1932) on the separation of ownership and control in modern corporations and to Joseph Schumpeter's thesis (1950) that firms were becoming more bureaucratic. The central premise of these studies was that modern joint stock companies involve a divorce between the ownership and the control of assets. Shareholders own the assets of a company but management control their use.

This separation of ownership and control is an example of an 'agent-principal' relationship. Agents, in this case management, are appointed by the principals, shareholders, to control the use of their resources. This relationship lies at the heart of the 'managerial' theories which incorporate the pursuit of non-profit maximising goals - such as sales, corporate growth or managerial utility maximisation, as well as non-maximising behaviour, such as 'satisficing'. A main feature of these theories is the contention that management are capable of pursuing objectives which increase their own well-being rather than the well-being of shareholders.

The ability to pursue non-profit maximising goals is important to the public vs. private debate. If information was perfect, then shareholders would be able to identify, and therefore prevent, non-profit maximising behaviour. In reality, however, information is imperfect and the theoretical maximum profit will be unknown to shareholders. This, some economist have argued, permits management to achieve a 'satisfactory'

level of profit - one which keeps shareholders happy - while at the same time pursuing their own pecuniary and non-pecuniary goals, e.g. high management salaries and fringe benefits (economic rents) and 'an easy life'. On the other hand, shareholder utility is dependent upon profit because profit determines both the level of dividends (income from assets) and the share price (capital growth). Hence shareholders buy and sell shares according to their perception of current and future profitability and this is directly a function of how well their assets are managed. If management lose the confidence of their shareholders, the company is likely to become a candidate for takeover by new management. Thus managers cannot ignore the interests of their shareholders and this establishes an important constraint upon non-profit maximising behaviour in the private sector. In addition, today management often has a direct interest in profits achieved because of the existence of performance bonuses, stock options and the like.

This need not be interpreted as suggesting that private sector companies are always efficient. The capital market constraint is not entirely effective because shareholders lack perfect information. Management may be able to conceal inefficiency, especially if similar levels of inefficiency exist in competitor firms. Also, the extent to which the 'takeover threat' does constrain managerial discretionary behaviour is unclear. Studies of the operation of capital markets present a mixed picture. It is not always the inefficient that succumb to predator firms; while takeovers do not necessarily produce gains in efficiency (e.g. Singh, 1975; Meeks, 1977; Lawriwsky, 1984). Grossman and Hart (1980) suggest that the dispersed nature of shareholdings can act to

thwart the takeover constraint upon management. Shareholders, even in the face of a declining share price, may hold on to their shares in the hope of benefitting from a recovery in price.

Nevertheless, the conclusion remains that the principal-agent relationship in the private sector limits non-profit behaviour by management. Management in public joint stock companies, the main private sector alternative to nationalised industries, may pursue their own pecuniary and non-pecuniary goals, but such activity is constrained, if not eliminated, by the existence of the competitive capital market. Thus the 'managerial' theories in economics, developed initially in terms of private sector companies, would appear to be more apposite where there is no competitive capital market. In other words, they would appear to apply best to the public sector where not only is there no takeover threat but the principal-agent relationship is highly fragmented.

Agents, principals and state ownership

Paralleling the existence of the manager - shareholder relationship in the private sector is the division in the public sector between the departments of state, 'quangos', boards of state enterprises, which manage assets on behalf of the public, and the public, which (at least in principle) own the assets. Intervening between managers as agents and the public as principals are layers of control involving civil servants, government ministers and MPs. Therefore, the agency relationship in the public sector is far more intricate than in the private sector. This simpler agency relationship in the private sector adds weight to the argument that privatisation raises efficiency. The difference in the agency relationship in the private and public sectors is summarised in Figure 1.

(Figure 1 here).

In UK nationalised industries there is a series of agents or sub-agents between the public and boards of management. This complicated agency structure between the public as principals and board management as ultimate agents increases the probability that management will pursue their own goals at the expense of efficiency.



Managerial behaviour and objectives in state enterprises can be expected to differ from the goals the public supports because of 'noise' in the information flow from principals through sub-agents to the decision takers. The wishes of the public are distorted or even ignored because of the lack of an effective channel of communication. Each level in the agency structure can be expected to introduce its own interpretation of th 'public interest'; while the ballot box, writing to MPs and opinion polls are only likely, at best, to be partially effective in limiting the actions of agents. Moreover, the government and boards keep the public inadequately informed to judge the true performance of their industries; and individual members of the public are unlikely to invest the time and effort necessary to overcome bureaucratic misinformation. The saving to the single taxpayer from higher efficiency is relatively small, while trades unions and other special interests have more to gain from lobbying MPs, government and boards, and by concentrating pressure, are likely to be more effective; especially when MPs are sponsored by public sector unions. State industries and their regulators, therefore, are under constant threat of 'capture' by interest groups.

It does not follow, of course, that the public will necessarily want state enterprises to maximise profit above all else. For example, the public may wish to see price rises suppressed or loss making plants kept open to preserve jobs. But the important point is that the existence of such goals in the public sector weakens the monitoring of agents. It becomes convenient for politicians, civil servants and public boards to conceal inefficiency by appealing to a vague notion of 'the wider public interest'. The 'public choice literature on government failure

(Mitchell, 1988) stands in stark contrast to the earlier Weberian model of bureaucracy in which disinterested bureaucrats can be relied upon to pursue the 'public interest'.

The failure of public enterprises to rationalise and transform their finances, e.g. British Rail traditionally and British Steel in the 1970s, alongside evidence of private sector firms taking tough decisions to reverse losses in trade downturns (Redwood, 1984), is a consequence of the different agent-principal relationships in the public and private sectors. In the 1980s the performance of state industries has improved dramatically in the UK (Treasury, 1987), but this has resulted it seems from the government's determination to inject new management and commercial objectives. In other words, it has made the state industries operate as if they were private sector companies. The government's resolve to maintain a commercial goal has no doubt been bolstered by its desire to privatise the industries. Earlier governments lacking the same resolve were quickly side-tracked into using nationalised industries to meet macro-economic objectives.

The deficiencies of the Morrisonian public corporation in the UK derive from the agent-principal relationship; a relationship paralleled in other forms of 'public ownership' - government departments, agencies and 'quangos' and local authority control. In the case of local authority services, the public remain ultimate financiers of trading deficits, through local taxation, and face tiers of local rather than central agents, including the local political machinery. This begs an obvious question - is local bureaucracy likely to be more representative and

accountable than national bureaucracy? Only if the answer is yes can we safely presume that a move from centrally to locally controlled state enterprises, favoured by some Labour activists, will improve operating efficiency. Currently, there appears to be no evidence to support this view.

### The role of the product market

So far we have been primarily concerned with the agency relationship in the public and private sectors. But the enthusiasm of government ministers for privatisation derives also from faith in the role of competition. Economic theory suggests that where there is considerable competition in product markets, firms must sell at the going market price or close down. If a firm is inefficient, its costs of production will be higher than those of its competitors and it will not survive. Therefore, competition places a severe limitation upon the ability of management and workers in the public and private sectors to pursue their own goals which raise production costs. In other words, competition in *the product market* acts as an important additional constraint alongside the capital market upon non-profit maximising behaviour in firms.

The importance of the product market is underlined by recent studies of public vs. private efficiency which conclude that there is no clear pattern of private sector superiority in industries where product market competition is limited, such as electricity and water (see e.g. Millward and Parker, 1983). This suggests that in the private sector a lack of

competition enables management both to satisfy shareholders and pursue their own goals, including an 'easy life', by the simple expediency of raising prices to consumers. Equally, it implies that in the public sector we should expect firms facing competition to be more efficient than state monopolies. This follows since monopoly helps to protect high costs, inefficiency, rent seeking and political over commercial objectives.

Also, because monopoly facilitates discretionary behaviour by agents, we should expect state enterprises to be associated with artificial monopolies, and this is the case. In bus and rail transport, coal mining, gas and electricity supply, telecommunications and so on, in the post-war period 'public enterprises' were given statutory monopolies. Only on privatisation has some effective competition been injected into sleepy state monopolies; though arguably this has not gone far enough, especially in the cases of telecommunications and gas. Moreover an early opening up of coal supplies to full competition would probably do much more than the endless directives, enquiries and White Papers since the 1950s, to reverse the low productivity and capital write-offs which have plagued this industry.

The failure to inject more competition in telecommunications and gas (and to a lesser extent in electricity) on privatisation is itself a manifestation of the power built up by managements and trades unions in the public sector since nationalisation. The continuation of monopoly status reflects the success of incumbent management in preserving their 'freedom to manage' and the associated economic rents. A result

compounded by a government keen to privatise speedily and without adequate attention to the source of efficiency gains. Distinguishing clearly between the product and capital markets helps to clarify the strengths and weaknesses of any privatisation measure. To raise production efficiency appreciably requires not only a change in the capital constraint facing firms, and hence in the agent-principal relationship, but the existence of effective competition in the product market (Figure 2).

( Figure 2 here )

### Conclusion

The increased interest in the last two decades or so in the internal organisation of firms, and principally the behaviour and performance of management, has played an important part in the reassessment of the relative merits of private and state ownership.

It is the existence of tiers of agents in the public sector, alongside the imposition of statutory monopoly powers which leads to the expectation that state ownership is less efficient than private ownership. The different agency relationships in the two sectors means a different capital market constraint upon managerial behaviour. At the same time, monopoly power enables agents in the state sector to pursue discretionary goals without loss of market to more efficient private sector competitors. Thus while privatisation simplifies the agency relationship, large efficiency gains are likely to be associated with opening-up former state monopolies to effective competition.

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Figure 1

Flows of information between principals and agents  
in the public and private sectors

Private ownership

Public ownership

Principal:

Shareholders



Agent:

directors

Principal:

Public



Elected representatives (MPs)

Government ministers & government

'sponsoring' departments (e.g.

Department of Energy for British

Coal)

Tiers of  
agents

Boards of 'quangos' and

nationalised industries



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Figure 2

	<u>Incentives exist to be efficient?</u>			
	Public sector monopolist	Public sector competitive enterprise	Private sector monopolist	Private sector competitive enterprise
Capital market constraint	No	No	Yes *	Yes
Product market constraint	No	Yes	No	Yes

\* However, the private monopolist may be able to satisfy shareholders by raising prices so that consumers not owners bear the costs of managerial discretionary behaviour.

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