The Pakistan Development Review
30 : 4 Part I (Winter 1992) pp. 565–579

Distinguished Lecture

Economics of Market Socialism and the Issue of Public Enterprise Reform in Developing Countries*

PRANAB BARDHAN

I

Historically state socialism has had dramatic initial success in creating a basic capital goods base in early stages of industrialisation and in its spectacular feats of mass literacy and public health campaigns made possible by mass-based organisations and forces of human mobilisation unleashed by socialist revolutions in poor countries like China, Vietnam or Cuba. But from the post-mortem reports of the collapse of the command economy in different parts of the world it is now clear that centralised state socialism is largely incapable of coping with the technological demands of the increasing sophistication in product quality and diversity and the needs of quick flexibility in decision-making and risk-taking in a whole range of economic activities spanning the technological spectrum from agriculture to semi-conductors. There is no doubt that a more decentralised market-mediated allocation of resources and greater competition can correct much of the wastage and dynamic efficiency of the bureaucratic command system and introduce more agility and flexibility in economic decisions. But the big question is how effective the stimulus of competition and markets can be without large-scale private ownership.

In the 1930's debate on market socialism, when Oskar Lange proposed a way of combining the market mechanism with public ownership, the question raised by Hayek and the other Austrians about how to ensure motivation and incentive in decision-making without private ownership were not fully answered. Socialist planning may be able to mimic market prices, but the question remains, as Kornai (1986) posed it: "can ownership be simulated by an artificially created body, which is commissioned to represent society as the owner?" The idea has gained ground, reinforced by the failure of attempts at partial reform in some East European countries, that the answer to this question is unambiguously negative. Private ownership is regarded as indispensable for resolving the incentive and agen-

*Owing to unavoidable circumstances, the first discussant's comments on this paper have not been received.

Pranab Bardhan is Professor of Economics at the University of California at Berkeley, USA.

cy problems underlying Kornai's query. Privatisation is thus supposed to be the key to unlock the door of economic efficiency in the reforming socialist countries as well as in developing countries like India or Pakistan which has a large public sector. In this paper we address the key incentive and agency problems in the management of a public firm and claim that privatisation is not the only or even the better way of handling those problems. We then draw some lessons from this for the burning issue of public enterprise reform. In particular we propose a scheme for denationalisation without privatisation.

II

Some of the horror stories we always hear about inefficient public firms may have to do more with their being public monopolies than with the fact of their public ownership *per se*. Examples of efficient public firms in a competitive environment are many around the world. Contrary to popular impression, empirical evidence of significant efficiency differentials between public and private firms *after adjusting for* market structure (and regulatory policy) is quite scanty. As Vickers and Yarrow (1991) note in their survey of the evidence on ownership and efficiency, in competitive industries even in cases where private ownership seems to have the edge, competition rather than ownership *per se* is the key to efficiency. Similarly, Naqvi and Kemal (1991) cite interesting evidence from the large-scale manufacturing sector in Pakistan to suggest that efficiency levels are independent of the locus of ownership.

But the Lange-Lerner model of market socialism, in its preoccupation with the feasibility of price calculations ("getting the prices right"), has largely ignored the fundamental question that competition among public firms may not be enough to motivate their managers to maximise profits. Under private ownership the entrepreneur has a stake in the firm; he (she) gains or loses money depending on the performance of the firm. The salaried manager of a public firm has usually much less at stake, and therefore may not have the full drive or incentive to pursue the Lange-Lerner rules of the game. In particular, the latter operates under the built-in expectation of what Kornai calls "the soft budget constraint". Various political considerations interfere with the harsh exit mechanism of the market and the state remains as the ultimate bailer-out of losing concerns. Political accountability prevails over financial accountability. Kornai (1986) spells out the mechanisms of softening the budget constraint in terms of (a) subsidies – open-ended and negotiable, (b) soft taxation, i.e. easily arranged tax-reliefs, (c) soft credit – easy renegotiation of debt, often forced upon suppliers and other creditor firms, and (d) soft administered prices, often involving cost-plus pricing.

There are at least two conceptually separable elements in the essential soft budget constraint problem: one is an information or agency problem, the other is a political problem (largely involving the problem of credible pre-commitment on the part of the state). Let us take the agency problem first. The state, as the principal, even when it has the "political will" to demand efficiency of management, may not have the full information to sort out if the agent-manager's bad performance is due to factors beyond the latter's control or not. This agency problem is clearly absent in owner-managed firms under private ownership. But if one goes beyond 19th-century owner-entrepreneurial capitalism and looks to sectors outside the small-scale sector of trade, crafts, services and agriculture, large-scale enterprises under corporate capitalism also face qualitatively similar agency problems in management. With the separation between ownership and management in such a capitalist firm, the manager may not maximise the share value of the firm and may instead feather his (her) own nest or simply take wasteful or foolhardy decisions, and the large body of shareholders, the principal in this case, may have a difficult monitoring problem at hand: the individual investor has neither the ability nor the full incentive to monitor. Just as a socialist firm, as it is owned by everybody, is really owned by nobody, in the sense that nobody takes responsibility, similarly, when shares of a capitalist firm are owned by thousands or even millions of investors, one may have difficulty in ensuring the proper line of responsibility. Only a small part of the agency costs under corporate capitalism can be gauged from the astronomical salary raises the CEO's in American and British companies regularly give themselves – this is clearly a case of the soft budget syndrome, in respect of the shareholders' money rather than the taxpayers'.

Finance theorists concerned with the agency problem in corporate capitalism – for example, Alchian and Demsetz (1972); Jensen and Meckling (1976); Fama (1980) – claim that the primary disciplining of managers comes through (a) the capital market and (b) the managerial labour market (both within and outside the firm). In principle it is possible to reproduce (b) under market socialism, if managerial reputation and future wages crucially depend on the performance of the currently managed firm (although it requires time and considerable depoliticised institution-building, but not necessarily a capitalist property system, to nurture a corporate culture of competitive bidding in the market for professional managers). But reproducing (a) without private ownership is much more difficult. Socialism essentially lacks an institution like the stock market which is supposed to provide a mechanism of continuous assessment of managerial performance. The threat of corporate takeover is supposed to keep the managers honest and the firm efficient, and thus to resolve the conflict of interest between those who bear risk and those who manage risk.

But the financial discipline of corporate takeover is usually a delayed and wasteful process. Jensen (1989) notes that in the U. S. the fact that takeover and leveraged-buyout premiums average 50 percent above market price illustrates how much value corporate managers can destroy before they face a serious threat of disturbance. Even in the takeover process there is a basic asymmetry of information: managers are more informed about the real reasons of a firm not performing well than outside buyers. As Stiglitz (1985) suggests, takeovers are like buying "used firms" and Akerlof's "lemons principle" applies here as well.

We also should not forget that the threat of corporate raids, a peculiarly Anglo-American game, has not been necessary for strong performance in some countries in continental Europe (like France or Germany), and particularly in Japan. The predominant practice in postwar Japan (at least until the middle 1970s) of mutual stock-holding of private companies within the *keiretsu,* a corporate financial grouping, often with a "main bank" as the nucleus, provides an important alternative model of monitoring by involved parties. We have drawn upon some of the features of the Japanese system in our proposed alternative financial system of monitoring under market socialism in the next section.[1] Even in the U. S., as Jensen (1989) points out, in recent years new organisational forms (the leveraged buyout association is a major example) are evolving, in which the key organisational principle is the active involvement by investors who hold large equity or debt positions in the long-term strategic direction of the companies they invest in. In other words, in the trade-off between risk diversification (facilitated by the diffuse stock ownership system) and control (which is diluted by that system), the balance is shifting in favour of more control by large investors.

III

In our proposed scheme, the state will not directly own a public firm. It will be a joint stock company with some of its shares owned by its workers, but also a major part of its shares owned by other public firms (including their workers) in the same financial group together with the main investment bank and its subsidiaries. The share-owning workers in one firm will have the motivation and some leverage in prodding other firms in the group to maximise profits. Some shares will be owned by companies outside the group, other financial institutions, pension funds, local governments, etc. The firm will also borrow from the main bank (which may sometimes organise a loan consortium for the firm) and those loans are convertible

[1]As M. Aoki has pointed out to us, in Japan there are two, overlapping but conceptually distinguishable, types of *keiretsu:* one is a financial corporate grouping across industries, bound by mutual stock-holding and a main bank as the nucleus; the other is a hierarchical grouping of firms connected by inter-industrial input-output relations, with a major manufacturing firm at its apex. Although in our proposed system we emphasise the former, there are one or two institutional features that we have borrowed also from the latter system.

into equities under some pre-specified conditions.[2] As Horiuchi (1989) suggests for the Japanese system, the primary role of the main bank may be that of what Diamond (1984) has called "delegated monitoring": through its commitment to the affiliate firm the main bank communicates to other investors and lenders about the firm's credibility.

The shares of a firm can be sold to the main bank. At the first signs of significant attempts at unloading by other firms the shares of a particular firm and usually much earlier, the main bank will take measures to prod and discipline the management, renegotiate the debt contract if necessary, orchestrate financial rescue strategies, help the firm with interest moratorium and emergency loans, and arrange for technological assistance from affiliated firms and for temporary selling of the firm's stocks in the latter to make up for its operating losses. With the bank's substantial share holdings it will even have the power to temporarily take over the management of the ailing firm if necessary. (In cases where bankruptcy cannot be prevented, the assets of the firm will be disposed of by the bank among a number of other enterprises.) Aoki (1988) gives the example in Japan of Sumitomo Bank taking over the management of the distressed Toyo Kogyo Company, the maker of Mazda cars, in the mid-1970s, until it was salvaged and nursed back to health. The main bank is motivated to arrange the rescue operation (a disproportionate share of the cost of which is borne by the main bank) since it wants to retain its reputation or credibility as a delegated monitor (in a system of reciprocal delegated monitoring with a small number of other main banks who do it for their affiliate firms) and since otherwise it may lose the intangible asset it has accumulated specific to its relationship with the affiliate firm. In the Japanese case long-term workers have also an incentive to work harder in order to avoid liquidation of the firm (which involves a significant loss of firm-specific benefits and seniority). As Berglof (1989) has found in his comparative study of alternative financial systems, creditor reorganisation of problem firms is relatively common in bank-oriented financial systems. Such reorganisation is more informal and less costly than involvement by outsiders (like courts or corporate raiders), and is also in line with the incomplete contracting approach to capital structure in the literature [see, for example, Aghion and Bolton (1988)] where the parties agree *ex ante* to let the banks act as reorganisation specialists. Even in the United States venture capital often plays a similar role, in getting involved in active management of a company in times of trouble.

The maximum size of a corporate group should not be very large and would depend on the monitoring ability and technical and financial expertise of the main bank. On the other hand, it should not be too small, at least for the sake of risk

[2]When lenders are also important equity-holders, credit-rationing and other onerous terms of lending may be largely avoided, and more risk-taking encouraged.

diversification. It will be desirable for members of a corporate group to be technologically somewhat inter-related, either at the vertical upstream-downstream level or at the horizontal contracting level. This is for three reasons: (a) technological inter-relatedness makes it easier to be somewhat knowledgeable about one another's production and market conditions, so that sharing of information, closer monitoring and early detection of trouble become feasible; (b) there may be spill-overs in the results of R and D, so that the usual externalities in the generation and diffusion of technology can be internalised within the mutual stock-holding corporate group; and (c) it becomes easier for the main bank to specialise in some relatively narrow and well-defined technological area for the purpose of monitoring and scrutinising its loans and equity involvements in the associated companies. On the other hand, if the technologically interrelated firms are prone to have covariate risks, the main bank needs to have a sufficiently diversified portfolio of loans and equities in firms outside the corporate group to reduce the danger of bank failure.

The proposed bank-centric financial system thus solves in a major way the planner-manager principal-agent problem and does it in a potentially better way than the stock market-centric system. The main bank and the group partners have a larger stake in and more "inside" information about a company than the ordinary shareholders in a stock market-centric system, are likely to be capable of detecting and acting on early signs of trouble (at least the collective action problem is somewhat less acute in what is basically a mode of internal conflict resolution), and are prone to take a longer view in the matter of risk-taking and innovations (i.e. they will be more tolerant of temporary low returns). Under the stock market system even fully rational investors, in a situation of highly imperfect information about the activities of the firm, may be too much concerned about short-run profitability. This is partly confirmed by Berglof (1989) who notes that a feature that distinguishes the bank-oriented systems from their stock market oriented counterparts is the longer-term shareholdings in the former.

IV

But the major problem of depending on the main bank as the primary monitor of the public firms in a corporate group is the inevitable question: who monitors the monitor? If the main bank depends substantially on the state for finance, the political aspect of the soft budget constraint again looms large, and the politics of soft budget expose, so to speak, the soft underbelly of socialist economics.

Whenever the beneficiaries from a state policy of leniency in underwriting losses, in refinancing or in providing relief or subsidies are concentrated and highly visible while the costs of such a policy are diffuse, there is inevitable political pressure on the state to follow such a policy, whether in a capitalist or in a socialist country. But such pressure is clearly more irresistible in the latter than in the former. In capitalist countries, while large bail-outs by the state are not uncommon, the prevailing hegemonic ideology makes lay-offs and bankruptcies politically more tolerable. All systems make costly mistakes from time to time; under socialist monitoring (including under our proposed system) what are called Type 2 errors (viz., bad projects are allowed to continue too long) are likely to be more common than Type 1 errors (viz., projects abandoned too soon) that seem to characterise the harsh, if occasionally myopic, exit mechanisms of capitalist market economies. Different societies have different degrees of tolerance for these two types of error. Societies that value stability and security more than mobility and change seem to have a larger degree of tolerance for Type 2 errors.

While it is difficult to get away completely from the politics of the soft budget constraint, there are some reasons to believe that they may be less virulent under our proposed insider monitoring system with proper safeguards. Let us spell out these reasons:

(a) In our system between the state treasury and the public firm which is an independent joint stock company, there is a hard layer formed by equity-holding technologically interdependent affiliate firms and the main bank which orchestrates the reciprocal monitoring. This layer provides some financial discipline on public firms and acts as a buffer against directly political accountability. This is, of course, not enough to prevent the whole affiliate group from acting as a lobby with the government for a troubled member.

(b) The reputational concerns of the main bank managers may act as an antidote to easy susceptibility to political pressures. In Japan even though the banks have been closely regulated by the Ministry of Finance, there is some keenness on the part of the bank managers to preserve their reputation as good monitors, and there is competition among banks in seeking the position of main bank for well-run firms. In our proposed system it may not be difficult to keep track of the reputational record of bank managers, since the number of main banks will be relatively small. The managerial labour market may not "forget" if a bank manager "forgives" bad loans or non-performing firms on his (her) watch too often.

(c) It is obviously important to introduce incentive features in the payment structures of main bank managers linked to their monitoring performance of the firms. While the social loss from a bad project may be many times the resulting loss to the bank manager's linked income, it may be a significant enough fraction of his (her) income to make negligence rather costly.

(d) It is absolutely important to keep the doors of international competition open, as a check on the institutional monitors' laxity. The use of international market signals can also provide valuable guidelines and comparative reference points in the main banks' monitoring process and raise cost and quality consciousness all around. There are obviously some genuine cases for infant-industry protection, but to prevent the much too common degeneration of infant industries into inefficient geriatric protection lobbies, there should be a clearly specified fixed duration announced for such protection, after which the firm has to sink or swim in international competition. To make such pre-commitments credible some binding international trade agreements may be tried.

(e) It is often claimed that under the soft budget constraint the state remains as the risk-absorber of last resort, and so there is little incentive on the part of managers to avoid very risky projects. Yet in actual cases of public sector management one often finds too few, rather than too many, risks taken by the managers. This is largely because of too much accountability to the politicians: the managers are constantly wary of taking bold decisions that might be seen by their nosy political bosses as rocking the boat of the pre-existing patronage distribution system. Even in our proposed system it may be difficult for the state to credibly pre-commit not to intervene too often with the main bank managers' decisions. So some difficult-to-change constitutional guarantees on the infrequency of state intervention in the short to medium-run operations of the bank managers may be necessary.

(f) Although in our system the state is to directly own a majority of the shares of bank, some significant fraction of the shares is to be owned by pension funds, insurance companies and other banks, to allow for some diversification of interest and professional control in the main bank's operations.

One major problem in our proposed bank-centric corporate groups is the possibility of collusion and industrial concentration facilitated by interlocking shareholding and exchange of inside information. It is therefore very important to preserve the discipline of product market competition (along with some anti-trust regulations) in this system. In the formation of these corporate groups it is necessary to keep major competitors in separate groups around different main banks. In our proposed system we are not ruling out cases of a firm leaving one corporate group and joining another (although in the Japanese case the relationship between a main bank and its customers is usually quite stable), but new entry applications to a group should be subject to strict scrutiny against collusion possibilities by an independent anti-trust authority.

There are some situations, particularly when the market size is small, where economies of scale considerations may make it difficult to have many competing firms in the same industry. In these situations a corporate group with mutual stock-holding among companies linked in input-output interdependence might be helpful in providing some mutual accountability. For example, a steel firm having a stake in a coal company belonging to the same group may, through its own levers of control and those of the main bank, pull up the latter if it indulges in monopoly-induced sloth and high costs. Of course, partial vertical integration through mutual stock-holding may increase market power and make new entry difficult. It is here that international competition can provide a crucial safeguard. There are lessons to learn here from the cases of South Korea and Taiwan where the state has often energetically used the carrot of easy loans and other benefits and the stick of international competition to prod the firms (many of them in the public sector) on to the technological frontier.

V

Let us now take up the issue of public enterprise reform in developing countries like India or Pakistan and consider the implications for this of the foregoing analysis of market socialism.

First of all, a minimum necessary condition of this reorganisation is to introduce competition. More than two-thirds of output produced by public sector enterprises in India, for example, is currently under monopoly conditions. Mere privatisation, converting a public monopoly into a private monopoly, will shelter the same kind of inefficiency, and be worse in terms of concentration of economic (and political) power. Easing entry barriers both in capacity licensing and in foreign trade will undoubtedly bring more market pressure on public firms and raise their cost-consciousness. In the core industries, like in the steel-power-fuel-transport complex, economies of scale considerations may sometimes limit the number of viable firms in an industry. But, as we have noted at the end of the preceding section, in our proposed system of mutual stock-holding in a given financial group there is some mutual check, as a public steel firm will have a significant stake and control in the operating efficiency of an affiliate public coal firm.

We also have seen before that competition is not enough to ensure responsibility in investment and management decisions. We have discussed some of the agency and political problems involved and ways of safeguarding against them. The principal-agent problems are often much more serious in the actual operation of the public enterprises because (1) the public firm often faces multiple goals, and a manager (or his or her political patron) can sometimes explain away the non-performance in making profits by referring to other goals of the firm (like employment creation or job protection, self-reliance or indigenisation of materials supply, industrialisation of backward areas, etc.), and (2) there are multiple organs of the government (too many "principals") exerting control over the firm management (the relevant production Ministry, the Bureau of Public Enterprises, the programme implementation Ministry, influential MP's, the various auditing and investigating agencies and so on), which, on the one hand, dilutes the manager's responsibility and, on the other, makes him (her) too vulnerable.

Financial profitability has to be unambiguously announced as the primary goal of the public firm (this is particularly salient in the context of the acute fiscal importance of generating public sector surplus). All other goals, however worthy, are to be openly serviced not through commands on public enterprises, but by direct and goal-specific subsidies from the government, the cost of which should be separately budgeted and made transparent for the purpose of public discussion. (For example, the goal of employment creation calls for a direct payroll subsidy; the goal of encouraging indigenous production of materials and components calls for a direct production subsidy to their producers.) For keeping public firm profitability at the centre stage, it is necessary, on the one hand, to discontinue most distribution and price controls on the output of public firms, and, on the other, remove all special input and credit subsidies. Privileged access of public firms to subsidised credit, for example, leads to costly distortions in managerial decisions: as Kelkar (1989) has pointed out, at every stage of a public sector project capital is substituted for good management (in the form of overdesigning at the project stage, low capacity utilisation, poor maintenance of plant and equipment, over-large inventories, etc.).

In our proposed financial system the public firm management is accountable only to the major share-holders, particularly the other affiliate public firms in the financial group and the "main bank", not to the various organs of the government. In India the state-owned financial institutions are heavily involved in industrial finance, but they usually play a relatively passive role on the issue of efficient management of the firms they control. We are envisaging here a major restructuring of these financial institutions and activisation of their monitoring functions on the lines delineated in Sections III and IV, or, preferably, creation of new financial institutions for this purpose. One should also note that our financial monitoring system is quite different from the idea, floated in India from time to time, about reorganising groups of public sector enterprises in the form of holding companies.

Of course, as long as the umbilical cord between the financial institutions and the state remains, the problem of soft budget constraint will persist. Hence the necessity of the safeguards discussed in Section IV, particularly those relating to substantial incentive payment in the salary and promotion of the managers of financial institutions linked to their monitoring performance of the public firms and the financial discipline of international competition (tradeable product prices linked to import prices regulated only by moderate tariffs). A constitutional amendment forbidding Central and State governments from providing revenue support to losing public firms and enforcing budgetary discipline will be necessary to make the state's commitment of non-intervention more credible. Similarly, there should be, as Sah and Weitzman (1991) have suggested, well-publicised liquidation pre-commitments for public sector projects *before* they are launched, if their cumulative performance at pre-specified dates in the future is not above certain threshold level. The rescue strategies by the main financial institution of a corporate group that we have indicated in Section III will be subject, by prior legislative enactment, to this kind of liquidation pre-commitment.

Of course, the major constituency opposed to liquidation or scaling down of unprofitable enterprises is the workforce. As Jalan (1991) has observed, in Indian public enterprises today, while the chief executives have unsecure tenure, the rest of the employees enjoy total job security. Not merely are their jobs protected even in the most hopelessly losing public sector enterprise, but when a private sector concern falls "sick", the political pressure is on the state to take it over to protect the jobs. In this way the public sector has become a charitable dispensary of chronically sick firms. This is, of course, politically the most difficult nut to crack. In public enterprises where year after year the revenues do not cover even the non-wage costs, it is cheaper to shut down the enterprise and keep on paying the workforce on some kind of a welfare payment system. All kinds of "golden handshake" schemes and adjustment and training and transfer programmes can be thought of. Sah and Weitzman (1991) have pointed out the advantages of profit-sharing payment schemes in this context. If pre-commitment to profit-sharing is part of a public sector project right from the beginning and if workers must sign on to this provision when they take a job, then in chronically unprofitable concerns the attraction of clinging on to the job is obviously much less and to that extent the resistance of the workforce may be weaker.

With regard to managerial personnel policy, both at the level of the monitoring financial institutions and that of the public firms, new systems making for increased professionalisation and depoliticisation in appointments, promotions and dismissal have to be devised. This is particularly important in view of the widespread practice of using public sector management jobs or membership in the boards of directors of nationalised banks as political sinecures and of automatic promotions for the administrative personnel without much reference to performance or technical qualifications for the specific job. In this context we approve of Jalan's suggestion of the creation of a new autonomous body for recruitment of managerial personnel with somewhat similar terms of reference as the Union Public Service Commission. This should be dovetailed with a vigorous managerial labour market competing with the private sector.

We do not have any illusion about the formidable problems, political and administrative, that such suggestions for drastic reforms will face in implementation. The vested interests (particularly in the bureaucracy, politicians and the unions) for preserving the *status quo* (often converting new organisational ideas into hollow rituals) are enormously strong. Yet one hopes that new ways of thinking about this vital part of the economy will someday generate enough pressure to bring about desperately needed changes. One can only point out that the institutional problems in reform implementation in countries like India or Pakistan are probably somewhat less severe than what socialist economies in Eastern Europe are currently facing: both countries have a vigorous mixed-economy base, a framework of market competition already in place, although not in the public sector, and a viable pre-existing legal, contractual and financial system which one can mold for the purpose of reform – in Eastern Europe much of this needs to be built from ground up.

REFERENCES

Aghion, P., and P. Bolton (1988) An 'Incomplete Contract' Approach to Bankruptcy and the Financial Structure of the Firm. MIT: Department of Economics. (Working Paper.) March.

Alchian, A., and H. Demsetz (1972) Production, Information Costs, and Economic Organization. *American Economic Review,* December.

Aoki, M. (1988) *Information, Incentives, and Bargaining in the Japanese Economy.* New York: Cambridge University Press.

Berglof, E. (1989) Capital Structure as a Mechanism of Control: A Comparison of Financial Systems. In M. Aoki, B. Gustafsson and O. E. Williamson (eds) *The Firm as a Nexus of Treaties.* London: Sage Publications.

Diamond, D. (1984) Financial Intermediation and Delegated Monitoring. *Review of Economic Studies.*

Fama, E. (1980) Agency Problems and the Theory of the Firm. *Journal of Political Economy.* April.

Horiuchi, A. (1989) Informational Properties of the Japanese Financial System. *Japan and the World Economy.*

Jalan, B. (1991) *India's Economic Crisis.* New Delhi: Oxford University Press. (Forthcoming.)

Jensen, M. (1989) Eclipse of the Public Corporation. *Harvard Business Review.* September-October.

Jensen, M., and W. Meckling (1976) Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure. *Journal of Financial Economics.* October.

Kelkar, V. (1989) On Efficiency of the Public Sector. Merchant Memorial Lecture at Indian Institute of Technology, Bombay.

Kornai, J. (1986) The Soft Budget Constraint. *Kyklos*.

Kornai, J. (1986a) The Hungarian Reform Process: Visions, Hopes, and Reality. *Journal of Economic Literature*. December.

Naqvi, S. N. H., and A. R. Kemal (1991) The Privatization of the Public Industrial Enterprises in Pakistan. *The Pakistan Development Review* 30: 2 105 – 144.

Sah, R., and M. Weitzman (1991) A Proposal for Using Incentive Pre-commitments in Public Enterprise Funding. *World Development*. June.

Stiglitz, J. (1985) Credit Markets and the Control of Capital. *Journal of Money, Credit, and Banking*. May.

Vickers, J., and G. Yarrow (1991) Economic Perspectives on Privatization. *Journal of Economic Perspectives*. Spring.

Comments on "Economics of Market Socialism and the Issue of Public Enterprise Reform in Developing Countries"

Discussions of the pros and cons of the socialist and the capitalist system are much less frequent nowadays than they were only a few years ago. Participants in such discussions often managed to blur the issue by comparing the actual performance of one system with all its shortcomings with the outcomes of a theoretical version of the favoured system, such that the later could not fail to win.

With a view to this practice it is a relief to read Professor Bardhan's paper. The author goes great lengths to discuss the scheme he proposes and to identify the possible shortcomings deriving from the soft-budget constraint. In a way Professor Bardhan thus becomes the discussant of his own paper; in fact, I shall use some of his observations for my conclusions. Before coming to that point I first give two critical comments.

First, whereas competition with private firms often renders public firms efficient, the author doubts whether competition among public firms will have the same effect due to the soft-budget constraint. He then proposes to harden the latter among others through various prescriptions. I doubt very much if those are effective. If the public sector is soft, this is due to the way it applies the rules and much less to the softness of the rules it has formulated for its own actions. It is only natural that tough decisions are avoided or delayed where possible. This also applies to the market sector. But an important property of the market economy is precisely that hard decisions cannot be avoided there as long and as easily as in the public sector where production units can be spared by adjusting the production environment.

My second comment relates to the bank-centric financial system which is proposed in the paper, next to the prescriptions referred to above, as perhaps the main factor contributing to a hardening of the budget constraint. It does not become entirely clear however why the incentives to managers of public firms in this system will be strengthened. Only if the monitors from the main bank are critical, demanding and powerful people may the desired effect of maximum efficiency be reached. This condition may well be met in the context of a market economy; several examples are given in the paper. But it is doubtful if it will be met also in another context. Suppose that the performance of public firms will indeed be expressed in terms of profit and suppose further that the monitors in the main bank will really insist on maximisation of profits in the public firms which are part of their group. It may then well be much easier to achieve that goal by wrangling concessions from the government than by striving for production efficiency. In other words it is hard to see how the bank-centric system *per se* will improve efficiency among public firms.

But even when ignoring the above comments and considering only Professor Bardhan's own observations, I do not find the solutions he offers for the poor performance of public firms convincing. For, if the rules, contracts, controls and institutions proposed in the paper are effective, they are certainly very costly. And that only in order to mimic the operation of the market economy. After reading the paper it is hard to avoid the conclusion that, if the proposed solution is the alternative, a straightforward market system is to be preferred.

Let me emphasise that I am not against government intervention. As a teacher of public finance, how could I be? My message is the familiar one: let governments in developing countries concentrate on the tasks which cannot be left to the market due to the well-known market failures. So, let governments provide public goods like roads, canals, communication networks and so on, and education and health systems which are accessible to everyone. These are already difficult tasks, so governments are well-advised to concentrate their scarce resources such as tax revenues and organisational and administrative skills there and to leave other tasks to the private sector.

Peter A. Cornelisse

Erasmus University,
Rotterdam,
The Netherlands.