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Economic integration and privatisation under diseconomies of scale

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Abstract

In this paper we analyse whether it should be national governments that decide whether to privatise public firms (non-integration) or whether this decision should be delegated to a supra-national authority (economic integration). We assume that two countries form a single market in which there is free trade and that each country has one public firm and *n* private firms. We show that, if the supra-national authority decides whether or not to privatise public firms, aggregated politically weighted welfare is no less than if the governments take this decision. We also show that aggregated politically weighted welfare is no less if the firms are owned by the governments rather than a supra-national authority.

JEL classification: L33; Q28; F15
Keywords: International trade; Economic integration; Public firms; Privatisation

1. Introduction

In the late 1980s there was a consensus in Western Europe in favour of a mixed economy including both public and private firms. Local and central governments created or purchase firms in a variety of sectors of the economy (including manufacturing and the service sector) for reasons that ranged from ideology to short-term strategic planning. As a result, EU governments own a significant percent-

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age of the firms in the different sectors of industry in Europe.[1] EU countries have subsequently privatised some of their public firms in recent years. In 1979 the United Kingdom privatised many of its public firms, and more privatisations, albeit on a smaller scale, followed in the rest of the then EC in the 1980s. In the 1990s the creation of the Single Market sparked further privatisation. However, in spite of this privatisation, no consensus was reached among EU governments regarding the number of firms in the different industries that should remain in public hands. Some governments favour going as far as possible with privatisation, while others prefer to continue with public ownership. At one extreme stands the UK, where most public firms have been privatised, and at the other stand Italy and Spain, where public ownership is still a major feature of many industries.

The Treaty of Rome is neutral as regards public ownership of firms. This neutrality is the result of the EU's having to accommodate within it the different levels of state ownership of firms and the different opinions of its member countries. The Treaty does not question the ownership of public firms, but it does indicate that all public sector intervention must be neutral in the sense that it must not affect competition within the Single Market. For instance, there is a ban on state aid that might distort competition between member countries.

Parker (1998b, p. 23) argues that in spite of the neutral position maintained by the Treaty of Rome on public ownership, it has been recognised on some occasions that privatisation can be beneficial. For instance, in 1994 the European Commission indicated that the privatisation of public firms could, when governments deemed it compatible with their objectives, help to improve the competitive environment (European Commission, 1994, p. 11). In regard to this last question, it must be said that some countries are reluctant to privatise their state owned firms for fear that many will fall into foreign ownership.[2] On the other hand, the individual governments are reluctant to transfer national sovereignty over public firms to Brussels (Parker, 1998b, p. 22).

These arguments have led us to wonder from a theoretical viewpoint whether it is welfare-superior for each government to decide whether it privatises its public firms or for a supra-national body to be created that can decide whether to privatise public firms in different countries. For this latter case we also analyse whether ownership of these firms should be passed over to the supra-national authority.

The literature that looks at the decision whether to privatise public firms usually considers only one country and one public firm (see for instance De Fraja and Delbono, 1989, 1990; White, 1996; Willner, 2001). This literature has been extended to privatisation decisions when there is international trade (see for instance Fjell and Pal, 1996; Pal and White, 1998), but the extensions continue to consider only one public firm, with firms

[1] See, for instance, Parker (1998a) and McGowan (1993).

[2] Parker (1998b, p. 36) indicates that EU countries fear that the privatisation of their public firms will lead to a loss of national control over major industries, and that this has led some countries to limit the percentage of privatised firms that can be acquired by foreign investors. For instance in Belgium sales have usually taken place on the basis of a preselection of investors rather than through public share offers. In Spain, the privatisation processes staged in the 1980s involved the sale of minority share packages because the government did not wish to relinquish control of the firms involved.