Privatization, Public Deficit Finance and Investment in Infrastructure

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Abstract

The paper presents a theoretical analysis of the relationship between privatization and public deficit finance. Using a model in which the optimal magnitude of public asset sales is endogenous, we examine the extent to which privatization can be used to reduce taxes, or, to retire public debt, for two cases: in the first, standard case, privatisation proceeds are used directly to finance the public deficit, whilst in the second they are used in cost-reducing public investment in infrastructure. In the latter case the government gains through smaller deficits of remaining public firms, higher proceeds from profit taxation and a smaller net employment loss. Whether or not, and the extent to which taxes can be reduced or public debt retired, and the optimal degree of privatization in each case are shown to depend on a number of interacting factors. Of particular importance are the initial conditions with regard to public debt, the labour market, the quality of infrastructure, the potential scope of the privatisation programme, the corporate tax rate, and the unemployment benefit; also the factors that determine the effect on employment, the size of revenue proceeds, and the efficiency effects of privatization the structure of the markets in which public firms operate, the extent of public firm inefficiency, and public firm objectives. It is found that the second case will often be associated with a lower wage tax rate for any given number of privatizations and a greater optimal number of privatizations than the first.