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D00360

Distr.
LIMITED

ID/WG.[illegible]/7
18 August 1969

ENGLISH
Original: FRENCH

United Nations Industrial Development Organization

Interregional Seminar on Financial Aspects
of Manufacturing Enterprises in the Public Sector

Rome, Italy, 1 - 12 December 1969

THE PRICE AND PROFITS POLICY OF PUBLIC INDUSTRIAL ENTERPRISES[1]

by

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[1] The views and opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the secretariat of UNIDO.

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FOREWORD

DEFINITION

A public enterprise is an enterprise where the State holds a majority of the shares either directly or through the intermediary of a decentralized public body. Its legal status may take very varied forms, depending on the nature of the enterprise. In some cases, the State forms a holding company to handle the holdings (majority or otherwise) which it possesses in various undertakings. Examples of this are the Société Nationale d'Investissement in Madagascar or the National Development Corporation in Tanzania.

It should be noted that we shall deal here only with public enterprises in a market economy, for in a socialist economy prices are usually fixed by a central authority in the light of the economic and social objectives of the development plan.

THE DIFFERENT CATEGORIES OF PUBLIC ENTERPRISES

In different countries, public enterprises are found in the most varied branches of activity:

- Financial enterprises: banks, insurance companies;
- Public services: transport, postal services, telephones;
- Power: coal, electricity, oil, atomic energy;
- Trade: marketing boards, import-export offices;
- Industry: in this paper we shall deal only with enterprises belonging to this sector.

REASONS FOR STATE INTERVENTION IN INDUSTRY

Many examples can be cited of the intervention of the public authorities in the production process. The aim of such intervention is usually to make up for shortcomings in the private sector, particularly when:

- Investment is not sufficiently profitable for the private sector;
- The investment required is beyond the financing capacity of the private sector;

- The investment required is within the range of private national savings but beyond the financing capacity of potential individual investors, who cannot manage to join forces;
- Private investors are discouraged (justifiably or unjustifiably) by the political risks;
- The branch of industry in question is of special importance for the nation (arms and munitions, etc.);
- The State nationalizes an existing industry because it is in difficulties (as in the case of coalmining) and employment must be maintained;
- The public enterprise is aimed at the reorganization of an industry (as in the case of British Steel);
- The State's action is justified by the need to combat monopolies or to impose sanctions (as in the case of Renault after the Second World War).

Further reasons for State intervention may be found in the developing countries, where it may be that:

- The State must employ all the means open to it - especially its capacity to act as entrepreneur or shareholder - in order to achieve, within a given period, the targets laid down in the Economic and Social Development Plan;
- High-productivity modern manufacturing techniques can only be applied by large-scale enterprises, but the markets of developing countries are often too small to permit the establishment of several such plants so as to ensure healthy competition;
- It may not always be possible to allow free competition by imports on the domestic market because many developing countries are short of foreign exchange.

I. SITUATION OF PUBLIC INDUSTRIAL ENTERPRISES REGARDING COMPETITION

Preliminary note: It is only of interest to study the price and profits policies of public manufacturing enterprises when, as is usually the case, a reduction of prices implies a reduction of profits. In some cases a price reduction may lead to an increase of profits owing to a growth of demand, but when this is so, the policy to be followed is clear because the enterprise and the consumer (and incidentally the State) can be benefitted simultaneously.

Case 1. Where the public industrial enterprise is exposed to competition

This competition may come from other undertakings or from imports. An apparently monopolistic situation (no competing enterprises, prohibition of imports of the products manufactured) is often one of disguised competition because of possible substitution by other goods.

In a genuinely competitive situation, the freedom of manoeuvre of a public manufacturing enterprise is very limited, at least so far as price and profits policies are concerned. The example of Renault in France may be cited: in principle, this firm cannot have a specific prices and profits policy, because it is in exactly the same economic position as any other French car manufacturer. Sometimes, however, it has acted differently: a particular instance of this occurred a few years ago, when, on Government instructions, it concentrated on exports in order to reduce the national balance of payments deficit, while the other manufacturers concentrated on the home market. Renault also has a specific policy of plant location, based *inter alia* on regional development. In this case, however, it is hardly possible to speak of a specific prices and profits policy.

If the government intervenes in the production sector in order to promote economic development, this means that the State's activities as an entrepreneur, far from impeding or destroying the market economy, are aimed at increasing its efficiency.

What, then, in these circumstances, is the level at which a State enterprise should fix its prices?

(a) Prices should be fixed so as to yield a normal return on capital. If there are other enterprises of lower productivity in the market, it may be concluded that their survival is the result of an unhealthy situation which the government is aiming to rectify. It is normal, therefore, that such private firms should disappear without compensation, because they had had the chance to make their operations pay. It may also be, however, that the private enterprises are able and willing to reduce their prices.

The level of profits achieved by a public enterprise as compared with competing private firms gives some indication of its degree of efficiency.

(b) It may be that a public enterprise does not seek to make profits, however, and in this case the structure of prices and of demand will be distorted:

- If it is accepted that the public enterprise does not or is not authorized to take advantage of the shift of demand towards its relatively cheap goods and services to increase its output and thereby eliminate its profit-making competitors, this will lead to the existence of two market price levels, one public and the other private. This unusual situation is justified mainly in the case of public credit enterprises of limited resources whose function is to combat excessive interest rates charged by private enterprises;
- If the public enterprise is free to increase its output this will lead to the industrial sector in which it operates being progressively "nationalized" as a result of a series of bankruptcies and liquidations by competing firms. Such a situation is not generally desirable, but it may be justified - though only temporarily - where a small number of private firms have been misusing a monopolistic situation. This solution, resulting in the disappearance of the competing private sector, should be exceptional and should be applied only when the private enterprises are of a special type or are socially undesirable. In normal circumstances, it is impossible to justify the existence of two price levels, while the process of nationalization by the failure of private manufacturers is very costly and cannot, in general, be recommended to developing countries. Moreover, a public enterprise which does not attempt to make profits lacks the means to provide for the formation of capital.

(c) If the productivity of a public industrial enterprise is lower than that of the competing private firms, the protective measures taken to ensure it a minimum profit level will enable the private firms to make abnormally high profits. An effort should therefore be made to increase the profitability of the public enterprise.

(d) The following situation is also possible: in many developing countries, and particularly in former British colonies, "holding companies" have been set up with public capital. These holding companies have substantial interests in various sectors of the economy. In this case it may be justified to sell certain products at high prices so that some of the holding companies' activities can make profits for investment in other activities. Here too, however, this policy may lead to abnormal profits in the private sector, and is therefore to be avoided.

(e) In the case of public export enterprises, the policy may be to obtain the maximum amount of foreign exchange, even if the corresponding production activities do not yield the maximum profit. Marginal enterprises may be subsidized to this end. Thus, for example, the Ghanaian Government nationalized and kept in operation the gold mines which were running at a loss, leaving the others - in particular, Ashanti Goldfields - in the hands of the (foreign) private sector.

(f) A public enterprise sometimes delivers materials to another public enterprise: for xample, an iron and steel enterprise may supply sheet steel to a publicly owned car factory or shipyard, and the intermediate products may be sold at prices below the competitors' prices. This means that one branch of the public sector gets preferential treatment: a situation of this type seems to exist in Spain, where private and semi-public iron and steel industries and automobile factories exist side by side.

Primary enterprises often enjoy various advantages such as subsidies or preferential loans in order to ensure their stability expansion.

<u>Case 2. Where the public industrial enterprise holds a monopoly</u>

In this case, the production of the public enterprise is intended solely for the domestic market and is protected against competition from imports. In principle, prices may vary from marginal production cost to the price providing the maximum profit (monopoly price). The problem is to find the price level between these limits which best serves the public interest, this being the theoretical aim of all public enterprises.

Attention must here be paid to the criterion of the relative utility of various types of production: some goods are regarded as essential for the needs of the public or for economic development and others not. When the government attempts to guide the consumption habits of the population it is often necessary to take into consideration criteria of utility other than purely economic criteria. Thus, for example:

(a) A State tobacco and cigarette monopoly should sell at prices which bring in maximum profits, because these products are not essential for economic development or for the health of consumers and the aim is to secure the maximum revenue for the State budget. In this case, prices and profits policy coincides with fiscal policy.

In fixing tobacco and cigarette prices there are many possibilities open, for demand is relatively inelastic and there are no possible substitutes. Thus a rise in prices will usually lead to an increase in the monopoly's receipts. The main factor ruling out excessive price increases would be of a social nature: many smokers have low incomes.

(b) On the other hand, governments regard agricultural and rural development as indispensable, because the possibilities of industrialization are small or non-existent so long as agricultural incomes have not attained a sufficient level to provide an adequate market for industry. Within this context, it may be desirable to encourage farmers to use fertilizers, and when this is so, a public fertilizer enterprise should aim at the lowest possible prices in order to create the largest possible market (in terms of volume). If the enterprise makes a loss, it can be subsidized by the State.

Thus the price policies of public industrial enterprises may be very different depending on the utility of the goods produced.

(c) It has often been pointed out that if a public enterprise holding a monopoly used its profits to finance new installations, this would amount to exploiting present consumers to subsidize the capital requirements of future consumers. Nevertheless, this policy may be justified in developing countries owing to the difficulty of finding financial resources outside the enterprise, especially if the product supplied is not a prime necessity.

Sometimes, however, public industrial enterprises follow the opposite policy: their prices are low and enable the private firms which buy from them to supply themselves cheaply and make excessive profits, while the public enterprise itself has to resort to loans or State subsidies to finance its investments.

The last two cases apply particularly to "public service" enterprises such as electricity suppliers, but they may also apply to public enterprises manufacturing intermediate products.

In the case of public enterprises manufacturing intermediate products care should obviously be taken not to favour private enterprises unduly at the expense of the community as a whole, and public enterprises should sell their products cheap only for serious economic and social reasons.

II. PRICE STANDARDIZATION POLICY

The prices of goods may vary widely on account of transport costs, depending on the location of the selling point. To put all consumers on an equal footing, the government may decide to standardize prices by making them the same in all parts of the country (or at least by reducing the discrepancies), so that the consumers best placed geographically pay a surcharge which is used to subsidize the others.

Such a policy, of course, can be applied equally well to private and to public enterprises, but governments are more inclined to apply it to the latter.

This policy generally leads to a rise in the average price.

It is sometimes applied in fixing electricity tariffs, but examples can also be found in industry, as for example in Spain, where the public enterprise producing paper pulp sells the pulp at the same price throughout the country so as to compete with imported pulp.

III. BUDGET EQUILIBRIUM OF PUBLIC INDUSTRIAL ENTERPRISES

The budget equilibrium of a public enterprise obviously closely depends on the enterprise's price and profits policy.

In some cases, the public enterprise can only operate if it is subsidized by the State, although the subsidy is not always direct, but may take the form of tax concessions or loans at preferential rates.

Thus in Brazil, where inflationary tendencies are very strong, public sector enterprises often receive low-interest loans, which give them an economic advantage.

Subsidizing a public enterprise benefits the consumer, but the community pays for the subsidy.

While a public enterprise must take the consumer's interests into account, it must also try to increase its takings and use its production capacity to the best advantage in order to reduce the need for State subsidies as much as possible.

Depending on the situation of a public enterprise, its financing may take different forms.

In a competitive situation, legal and fiscal measures making it easier for public enterprises to achieve self-financing through high profits often enable private firms to make excessive profits also. It is preferable to reduce these excessive profits by taxation.

Just as private capital participates in the financing of new investments by private firms, so the State can assist in the financing of a public enterprise: when it does so it is not granting a subsidy, but is participating in the capital of the public enterprise against remuneration or making a straightforward loan.

On the other hand, a public enterprise holding a monopoly can finance itself without going to the community for money, and this simplifies management and financial procedures both for the State and for the enterprise.

Attention may be drawn to the fact - especially marked in the industrialized countries - that it is often the enterprises appearing to be least profitable which are left to the public sector, and this makes the self-financing of investments much more difficult for enterprises in this sector. But here a number of questions arise, such as:

1. Do private enterprises pay the real price for the services or goods sold by enterprises in the public sector?

2. Do private enterprises actually pay for all the costs which they occasion, for example, the costs resulting from the need to combat atmospheric pollution?

If these points were looked into more closely, this might facilitate somewhat the financing of investment in the public sector.

The price policy of a public industrial enterprise should therefore be guided by the following considerations:

1. The public enterprise should aim at the maximum utilization of its existing production capacity.

2. The public enterprise should stimulate certain types of consumption at the expense of others, according to their relative utility for the community. This, however, is primarily a task for the tax authorities.

3. The public enterprise should seek to achieve maximum efficiency.

A realistic price policy can only be established, however, when sufficient information is available on the environment in which the public enterprise operates, including, in particular, data on the present and future situation in the industry in question. If these are available, the prices and credits policy may be decided at three different levels:

1. At the level of the enterprise: this is usually the case with public enterprises exposed to competition;

2. At the level of a group of public enterprises, such as a holding company; and

3. At the government level: decisions at this level are mostly confined to the case of public enterprises whose production is regarded as essential for economic and social development.

In actual fact, the prices and profits policies of public enterprises mainly depend on the organization of the public sector.

THE ORGANIZATION OF PUBLIC INDUSTRIAL ENTERPRISES

[illegible] implies a division of responsibilities between the public administration and the management of public enterprises. [illegible] country [illegible] public enterprises [illegible].

It is difficult to set up [illegible] department responsible for the management of public enterprises [illegible] confined [illegible]. However, the working methods [illegible] the management of enterprises [illegible] techniques [illegible] and be capable of adapting himself to changes [illegible] environment.

But how can the autonomy necessary to public enterprises be reconciled with the overriding necessity to fulfil the production targets [illegible]? The solution consists of establishing within the [illegible] responsible for dealing with industry, an effective system of supervision ensuring liaison between the public enterprises and the State without restricting the day-to-day management of the firms.

In conclusion, it may be said that, generally speaking, public industrial enterprises have to act like private firms, except in the case of a genuine monopoly. The State should control their activities in the light of the interests of the national community. The public enterprise is an instrument which is at the State's disposal for assisting economic and social development.

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