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Privatisation and Nationalisation in the 21st century

Introduction

In economic terms, the dominant policy trend of the 20th century was that of nationalisation. In almost all countries, and on almost all measures, the range of economic activities undertaken by governments was substantially larger at the end of the 20th century than at the beginning, as was the ratio of public revenue and expenditure to national income.

During the last twenty years, however, there were sustained, and to some extent successful, attempts to roll back the growth of government. Centrally planned economies collapsed and began a transition towards a market-oriented model. In the developed OECD countries, privatisation of publicly-owned enterprises took place on a large scale, beginning with the sale by public float of British Telecom, undertaken by the Thatcher government in the United Kingdom in 1985.

These developments popularised a ‘triumphalist’ analysis, in which it was claimed that ‘capitalism’ had triumphed over ‘socialism’, inaugurating the ‘end of history’ (Fukuyama). This claim was clearly correct insofar as ‘capitalism’ referred to the set of economic and political systems prevailing in OECD countries, ranging from the United States to Norway, and ‘socialism’ referred to the systems prevailing in the Soviet Union. However, as was made clear by Fukuyama and subsequent writers such as Friedman (1999), a much stronger claim was intended. The claim was that history had shown the inevitably of a free-market system similar in broad terms to that prevailing in the United States, but with reductions in the role of government along the lines of those proposed in the Republican Party's Contract with America (Gingrich 1994).

Such claims were premature. Although privatisation reduced the role of government in the provision of marketed goods and services, the general government sector (health, education, community services and social welfare) continued to grow in absolute terms and, in many countries, as a proportion of GDP, throughout the 1980s and 1990s. Moreover, by the late 1990s, the pace of privatisation had clearly slowed. For example, whereas, before 1995, almost all proposals for privatisation in Australia had been successful, in the period after 1995 most were rejected.

In the first years of the 21st century, the rate of privatisation has slowed even further, particularly in Europe and Latin America. More significantly, in the English-speaking countries a countervailing trend has emerged. For the first time in decades, nationalisation or renationalisation has taken place on a significant scale. Notable examples include the nationalisation of airport security in the United States, the effective renationalisation of the railway system owner Railtrack in the United Kingdom and the establishment of a new publicly-owned bank in New Zealand.

Transfers

Privatisation and nationalisation frequently involve substantial transfers of wealth. Analysis of these transfers is useful for several purposes. First, it is important to distinguish between transfers of wealth and efficiency gains or losses arising from privatisation or nationalisation. Second, analysis of wealth transfers is an important part of any evaluation of welfare effects. Finally, the political economy of privatisation and nationalisation is largely determined by the direction and magnitude of wealth transfers.

Underpricing and buyer overoptimism

The most obvious transfers associated with privatisation by public float, as with private sector initial public offerings (IPOs) arise when the offer price for shares is set at a level below the market value of the shares, as revealed in early trading. In both the private and public sectors, there are incentives for the organisers of IPOs to set prices below the expected market price, thereby allowing those participating in the float to benefit from first-day 'stag' profits.

First, the negative consequences associated with a 'failed' float (one in which not all shares on offer are taken up) are generally greater than for a float that is oversubscribed. This is particularly true in relation to politically controversial privatisations, where a failure to purchase shares can be represented as a lack of confidence in the government.

Second, the allocation of underpriced shares provides opportunities to give favours to individuals and groups whose goodwill may be valuable in future. Such favours were a prominent and controversial feature of the recent stockmarket bubble in the United States. The allocation of discounted shares to employees and others has been a common feature of privatisation in Australia and elsewhere.

Transfers have also arisen in relation to privatisation by trade sale. In many developing and transitional countries privatisation by trade sale has been the occasion for large-scale expropriation of public wealth. Australian experience has been more favourable, from the viewpoint of the public. Although some assets, such as the NSW State Bank, appear to have been sold at unreasonably low prices (Walker and Walker 2000), there have been other instances, such as the sale of Victorian electricity distribution enterprises, where the price paid appeared unreasonably high in the light of the regulatory regime that determined subsequent earnings. In some cases, of this kind, such as the privatisation of airports, regulations have been relaxed to allow higher profits, retrospectively validating high sale prices.

Prices and service quality

The impact of privatisation on prices and service quality has varied, depending particularly on the nature of regulatory changes introduced at the time of privatisation. In general, direct impacts on prices have been small, except where governments have sought to increase the sale price of assets by raising costs to consumers. The most notable recent example was the leasing of Australian airports, which was accompanied by large increases in landing charges (up to 100%), increases in other charges, such as parking fees, and the introduction of a range of new charges, such as taxi levies.

Privatisation of monopolies, when combined with price regulation, has typically led to a reduction in service quality, as monopoly firms seek opportunities to reduce costs and raise profits. Over time, the introduction of steadily more intrusive regulation has reduced both the incentives for lower service quality and the differences in operational efficiency between private and public monopolies.

In some other instances, privatisation has led to the adoption of a more business-like and 'customer-focused' approach. This has typically been associated with an increase in the quality of service for profitable customers, but also with attempts to discard unprofitable customers and uncompensated community service obligations.

Safety and reliability

Privatisation has generally been accompanied by a decline in the safety and reliability of infrastructure services, particularly when account is taken of exogenous technological trends, which have generally improved the reliability of equipment of all kinds. The cost reductions associated with privatisation and, to a lesser extent, corporatisation, have focused particularly on reductions in overstaffing in areas such as maintenance and on the elimination of redundant capital capacity, frequently referred to as 'goldplating'. Other things being equal, cost savings achieved in this way must involve some loss of reliability and, in some cases, safety.

The shift from public to private ownership reduces incentives for safety and reliability. The political costs of failures in infrastructure systems can be severe. By contrast, the costs to private infrastructure owners of occasional breakdowns is relatively modest. Hence, if such outcomes are to be avoided, intrusive regulation is likely to be necessary.

Another possible response is the introduction of a legal regime based on strict liability of infrastructure providers for economic losses associated with system failures. A current class action against Esso in relation to the consequences of the Longford explosion and system failure in Victoria may set a precedent in this respect. Surprisingly, relatively few supporters of the adoption of the US model of private provision of infrastructure services seem to welcome the arrival of a system of regulation in which the threat of litigation plays a central role, as in the US.

None of the discussion above establishes whether the net impact of reductions in maintenance expenditure is positive or negative. Terms like 'goldplating' and 'redundancy' tend to imply that there is too much reliability, but goldplating makes sense in some contexts (computers) and redundancy in others (aircraft control systems).

Wages, conditions and work intensity

Like other aspects of microeconomic reform, privatisation has imposed costs on workers in the form of increased stress and a faster pace of work. Although anecdotal evidence of increases in work intensity abounds, statistical evidence is limited. The Australian Workplace Industrial Relations Survey undertaken in 1995 found that a majority of employees reported increases in stress, work effort and the pace of work over the previous year, while less than 10 per cent reported reductions in any of these variables (Morehead et al 1997).

Dawson et (2001) examine the increase in working hours for full-time workers and conclude (p 4)

> For many Australian workers, their families and communities, extended working hours have lead to increased levels of fatigue and decreasing levels of social support. This in turn has the potential to compromise safety and the long-term health and wellbeing of workers and the organisations that employ them.

Another source of evidence comes from the supply side. The combination of increased work intensity and longer hours of work has rendered full-time employment increasingly unattractive. The full-time participation rate (full-time employment plus those seeking full-time work as a proportion of the population aged between 15 and 64) fell during the 1990s for both males and females. The decline in female participation in the full-time labour force represents the reversal of a long-term trend towards increased participation.

Efficiency gains and losses

If all transfers to and from workers, consumers and taxpayers have been netted out, the impact of privatisation can be assessed by comparing the value of the enterprise in private ownership, measured by the sale price, with its value in continued public ownership, measured by the present value of the earnings that would have been realised under continued public ownership. The starting point for any such assessment is what may be called the 'equivalence hypothesis', namely, that in the absence of some specific source of efficiency gains or losses, the value of the asset will be the same in public or private ownership. Hence, in the absence of transfers such as those discussed in the previous section, privatisation will have no effect on the net worth of the public sector (Forsyth 1993).

In this section, a range of possible sources of efficiency gains and losses are considered. Although it is difficult to assess them individually, a market test is provided by a comparison of sale prices with earnings foregone through privatisation.

Operational efficiency

One of the strongest claims for privatisation is that it will increase the operating efficiency, and therefore the profitability, of the enterprises concerned. Empirical studies have yielded mixed results, although the balance of evidence favours the hypothesis that privatisation increases operating efficiency. Borcherding, Pommerehne and Schneider (1982) surveyed the literature on municipal services and reported that, in most studies, either the private sector was found to be more efficient or no significant difference was observed. However, in studies of electricity and water services, either the public sector has been found to be more efficient (Pescatrice and Trapani 1980; Bhattacharyya, Parker and Raffiee 1994) or no significant difference has been discovered (Byrnes, Grosskopf and Hayes 1986).

Historically, public enterprises have had a wide variety of objectives and it is reasonable to assume that many of the enterprises in the studies surveyed by Borcherding et al. (1982) had neither a profit-maximisation objective nor a cost-minimisation objective. One result of this diversity of objectives is the common finding that the variance of performance measures is higher for public than for private firms (Bhattacharyya, Parker and Raffiee 1994).

A central feature of public sector reform in Australia has been the attempt to replace the diffuse objectives of traditional public enterprises with an objective of profit maximisation subject to the satisfaction of clearly defined community service obligations. This has most commonly been achieved through corporatisation. Corporatised government business enterprises have competed effectively with private firms in many industries, suggesting that any differences in operating efficiency must be modest. It should also be noted that many of the wealth transfers associated with privatisation, such as uncompensated increases in the intensity of work, also arise in corporatised government business enterprises.

Regulatory risk

In some instances, such as cases where governments have owned firms trading in competitive markets, privatisation involves no changes in regulation. However, such cases, typically arising from public ‘rescues’ of failing firms, have been relatively infrequent. As public ownership expanded during the first 80 years of the 20th century, nationalisation was used primarily as a method of regulating industries that were, or were seen to be, characterized by market failures such as natural monopoly or externality.

In these circumstances, privatisation creates a regulatory risk that did not exist under public ownership. Small differences regulated rates of return imply large transfers between consumers and private monopolists. By contrast, under public ownership, this risk is internalised, since, for most regulated infrastructure services, consumers and taxpayers (or, more precisely, residents of the relevant jurisdiction) are the same people.

This analysis directly contradicts a widely held view of public policy in Australia, that there is, in some sense, a conflict of interest in governments both owning and regulating business enterprises. This view lacks any analytical basis. It is analogous to an argument that a conflict arises when a private company contracts with or directs the actions of a wholly-owned subsidiary.

The costs of regulatory risk are substantial. The failure of private buyers to take regulatory risk into account led to the over-optimistic prices paid for Victorian electricity assets. These purchases have been followed by resales and lower prices and by vigorous rent-seeking activity aimed at validating the original purchases prices by securing more favourable regulatory treatment.

Cost of capital

The crucial efficiency difference in favour of public ownership arises from differences in the cost of capital. The return demanded by investors in private equity in the average large company includes a risk premium of around 6 percentage points to compensate for the company's exposure to aggregate economic risk. That is, if the rate of interest on government bonds is 5 per cent, investors in a typical stock will expect a return of around 11 per cent.

The equity premium is smaller for companies with stable returns or for those that are only weakly correlated with the economy as a whole, and larger for those with highly cyclical returns such as companies involved in construction.

The market's aversion to risk is reflected in the difference between the return demanded by investors in private equity and the rate of return on government bonds or good-quality corporate bonds. This difference is called the equity premium, and its size represents a long-standing puzzle for economists. Most economic models imply that, if capital markets spread all relevant risks efficiently and at low cost, the equity premium should be no more than one percentage point, and probably less. A variety of explanations for the 'equity premium puzzle' have been offered, most of which incorporate the failure of private capital markets to spread risk as well as is assumed in neoclassical models of the financial sector.

As Grant and Quiggin (2002) observe, if the demand for a high rate of return on equity arises from failures in private capital markets, there is no reason to apply this rate of return in evaluating public investments, or determining the present value of income streams flowing from government business enterprises.

An assessment of Australian privatisations

As has been argued in this paper, the effects of privatisation can be assessed by examining the difference between the sale price realised for an asset and the present value of earnings foregone under public ownership, after netting out transfers to and from workers, consumers and buyers of assets. Such analyses of actual and prospective privatisations have been performed for the Commonwealth Bank (Quiggin 1995), Commonwealth Serum Laboratories (Hamilton and Quiggin 1997), Telstra (Quiggin 1996a), the NSW State Bank (Walker and Walker 2000) and the Victorian electricity industry (Quiggin 2002a) among others.

In all cases the analysis indicated a net welfare loss from privatisation. In the case of Victorian electricity, however, the loss was borne by the buyers (mainly US electricity companies) who paid prices which were, at least in retrospect, excessive. Hence, the net impact on Victorian residents was roughly neutral, with gains to taxpayers being offset by losses to workers and consumers.

Based on this evidence, it seems unlikely that privatisation of efficiently-run government business enterprises in 'core' areas of government activity such as infrastructure is ever likely to be beneficial, except during market 'bubbles', when buyers may be willing to pay prices that exceed the long-run private market value of assets.

The case for renationalisation

Thinking the unthinkable

Until about 1980, the idea of a substantial reduction in the scale and scope of public sector economic activity lay outside the realm of acceptable public debate. Cockett's (1995) classic study of the British thinktanks, such as the Institute for Economic Affairs, that first advocated privatisation, was aptly titled *Thinking the Unthinkable*. Such is the power of conformism in human affairs that within a decade of its entry into the public debate, the insurgent idea of privatisation had become an orthodox dogma, and the concept of nationalisation was, literally, unthinkable for many.

This point may be illustrated with reference to the Australian debate. Criticisms of privatisation, such as those of Quiggin (1995) and Walker (1994) have been the subject of vigorous debate (Hathaway 1997, Officer 1999). But until recently, arguments that the appropriate response to the failures of privatisation is a return to public ownership (Quiggin 2000) have simply been ignored.

This position is slowly changing, although the public debate is lagging events in the real world. Renationalisation in various forms has taken place in numerous countries, sometimes as a deliberate attempt to offset excessive privatisation, but more frequently in response to the failures of privatised firms and the associated regulatory structure. Notable examples include Railtrack in the United Kingdom, airport security in the United States, electricity in California and the re-establishment of a publicly-owned bank in New Zealand.

In Australia, the Minister for Small Business, Joe Hockey, recently suggested that it might be necessary for State governments to re-enter the insurance business following the collapse of HIH Insurance and United Medical Protection (ABC interview, reproduced at http://www.abc.net.au/am/s566044.htm). The unthinkable is becoming thinkable once again.

The mixed economy

In most OECD countries, governments and government business enterprises produce around 30 per cent of total output. This proportion has tended to grow over time, reflecting the increasing economic importance of the sectors in which government activity is concentrated, such as health and education. Large-scale privatisation has offset or reversed the increasing trend in a number of countries, including the United Kingdom. Nevertheless, it seems clear that, for the foreseeable future, OECD countries will have 'mixed' rather than 'free-market' economies.

In a mixed economy, even supporters of further privatisation, should welcome the availability of nationalisation as a policy option. If privatisation is, as is sometimes supposed, irreversible, it should be undertaken with great caution. By contrast, if both privatisation and nationalisation are feasible, it is possible to adjust the boundary between the private and public sectors optimally in response to new information and changed circumstances.

Nevertheless, the policy relevance of nationalisation is greatest in cases where privatisation has already gone too far. The evidence cited in this paper suggests that this in the case in Australia, and that a number of privatisations already undertaken have reduced both public sector net worth and the welfare of the community as a whole. It follows that, in the absence of transactions costs, renationalisation would improve welfare.

Targets for renationalisation

The strongest candidate for renationalisation in Australia at present is Telstra. Even supporters of privatisation, such as Treasurer Peter Costello, agree that the present state of partial privatisation is highly unsatisfactory. When the current government's proposal for partial privatisation was under consideration, the same view was expressed in Quiggin (1996b) and derided by members of the government. On the other hand, given Telstra's monopoly power, full privatisation would be acceptable to other market participants only if it was accompanied by more stringent regulation. The implied regulatory risk reduces the market value of Telstra, which is well below any reasonable estimate of the value of future real earnings, discounted at the real bond rate.

Privatisation of Telstra could be financed in part by the sale of peripheral assets, such as Telstra's pay-TV interests and joint ventures in Hong Kong. This idea, along with proposals for more extensive structural separation has been discussed by Quiggin (2002b) and Tanner (2002), and criticized by Eason (2002).

Renationalisation of infrastructure assets that have been fully privatised is further off, except in cases such as that of Railtrack where the private operator fails completely. Nevertheless, it would be highly desirable to restore full public ownership of the road system and to replace the present arbitrary patchwork of tolls with a rational system of road user charging. Less urgent, but still highly desirable, is the renationalisation of natural monopoly infrastructure such as water supply in South Australia and electricity distribution in South Australia and Victoria.

Concluding comments

The limitations and failures of privatisation are widely recognised, but the obvious implication, that at least some privatised enterprises should be renationalised, remains unthinkable for any. Thus far, renationalisation has occurred primarily as an emergency response to the failure of private firms providing essential services. As instances of this kind break down the notion that privatisation is irreversible, it may be possible to undertake a more systematic and rational reconsideration of the appropriate roles of the public and private sectors.

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