Kolsen on Privatisation

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1 General

The privatisation of assets currently in public ownership is frequently justified by claims that the de-privatised assets will operate more efficiently when privately owned. This is based on assumptions made without reference to the specific technical and economic characteristics of the privatised enterprise such as economies of scale, cost complexities or to any objectives such as the public service obligations usually performed by state-owned firms. The unqualified efficiency assumption is applied to all state-owned assets including ports, electricity, gas, water, roads, tunnels. No interest is displayed in examining the reasons for their de- or non-privatisation in the past. Apparently, our forebears just de-privatised without reasons, or simply as a reflection of the politics of the time, much like privatisation today.

It is necessary to dispose of some matters frequently referred to in privatisation discussions but very hard to believe. They include the idea that budget deficits can be reduced in the long run by selling income-earning assets and investing the proceeds in unspecified but non-income-producing assets usually referred to as infrastructure. Perhaps, in a low interest environment, a benefit-cost analysis might show that more investment in income-producing assets is a better solution. To produce a balance sheet which shows liabilities without reference to assets would not be acceptable to shareholders in private companies, and is no more acceptable to voters interested in state-owned enterprises.

Another assertion hard to believe is that a small number of companies earning hurdle rate profits 'competing' in the sale of electricity flowing down one wire into your house will reduce the price. More generally, asserting that selling an asset which pays the government hurdle rate - say 6% - will reduce the prices of its outputs when it pays a private market rate of say - 12% is definitely hard to believe. A reminder is needed that 'competition' between 2, 3 or 4 companies does not produce the same results as the competition between many suppliers, as envisaged in first year texts. Oligopolistic competition is not user-friendly.

It is sometimes possible to achieve these hard-to-believe results by subtle changes in output characteristics. The public service obligations (PSOs) will shrink as the objectives of the privatised enterprise respond to the requirements of the dominant profit motive. This may well be appropriate, with the desirability of subjecting such PSOs to a benefits-costs test. What is not appropriate is to leave such costs in the cost-revenue mix for the government entity, but not, or to a lesser extent, in the cost-revenue mix of the private firm when making comparisons between them.

It must also be recognised that the relations between a regulating authority and a publicly-owned enterprise will differ from the relations between it and a private firm. While cost complexities like joint and common costs, costs associated with long-lived and specific assets, and gold plating will, in many cases, baffle regulators regardless of asset ownership, there are cost inputs, such as the cost of capital, which will be different and therefore have different results. This can be obscured by using the opportunity cost of capital argument, which eliminates the advantage of the low risk state borrower. That reasoning is used in private-public partnership comparisons, and is a clever way of 'normalising' away the public sector advantage.

2 Some theoretical background

There was, and still is, a respectable body of economic theory which provides the necessary background for public investment in an economy in which most productive assets are privately owned. A standard few can be briefly mentioned. Any in-depth discussion would require a book. Of more interest are some matters which were once so well understood that explicit and extensive discussion seemed unnecessary. This understanding is no longer the case so that some reminding is necessary.

The basic (there are many more) economic and technical characteristics were economies of scale (economies of scope were added later), relatively undifferentiated outputs, an absence of effective substitutes, and wider effects on the community not able to be captured by private companies. Competition could not provide the market discipline on the price and output policies of such natural or legislated monopolies. While economists frowned on the use of government-owned assets for income re-distribution policies, they were widely used for that purpose. Some continue to do so to this day, even after privatisation, with Telstra a prime example. The cross-subsidies, in electricity, fixed-line telecommunications and postal services flow from densely- to sparsely-populated areas, which is also the case for many transport services.

Benefit-cost analysis was developed, initially intended as a practical arm of welfare economics to include benefits and costs which were not, or inadequately, represented in public investment decisions. While many practical uses were and area made, some aspects of the theoretical bases - slightly deeper than 'Economics 101' - have been conveniently pushed into the background, or buried altogether.

Two such matters can be briefly mentioned. One is the so-called theory of second best, which shows that adopting the assumption that all enterprises are perfectly or highly competitive except the firm under investigation would always show it to be inefficient, and would always be wrong. This is very inconvenient for model builders, and also requires some research into the price-marginal cost relationship in related firms. The other matter is concerned with effects of the investment in and operation of it on income re-distribution. The bitter pill was that the economists' box of tricks does not include judgments about income distribution.

So comparisons made between the performance of privately- and publicly-owned firms requires somewhat more sophistication than just comparisons of rates of return.

3 The Market Model: some deficiencies

While it is possible to criticise many aspects of privatisations past and proposed, this would run foul of the 'one shoe fits all' problem of which the proponents of privatisation make much use. As mentioned above, 'competition' in 'free markets' is undefined and assumed to achieve highly efficient results no matter what the actual circumstances might be. It is worth repeating that it is not reasonable to believe that 'competition' for the electricity that flows down one set of wires into your house will reduce costs. Or gas and water through one pipe. It is also worth repeating that the idea that all 'competitors' can earn a commercial rate of return with no increase in prices is against both economics and common sense. These and other absurd examples need no article-length critique.

Some additional problems are created by restricting the direct comparisons frequently made between privatised and publicly-owned enterprises to financial performance, which invariably fail to factor in the effects of different objectives. Privately-owned firms, even if regulated, are required to put the interests of their shareholders first. Benefits which cannot be financially captured do not count. A tunnel might be used as an example. Users of the relevant parts of the road system who do not use the tunnel benefit from lower congestion and lower travel time for which they do not pay, as a by-product of those who do use the tunnel and pay the toll. The sum of the benefits to users and non-users will usually greatly exceed toll revenue and might more than justify the cost. The overall result is beneficial for the system, but financial failure for the toll road owners. Insisting on private ownership thus severely limits provision of assets for which the value of benefits is greater than costs, but costs exceed the value of the benefits which can be captured by the private supplier.

4 Important wider effects of privatisation

It is necessary to draw attention to a couple of important matters which have not been accorded the attention they deserve. One of these is the reduced ability of governments to respond to matters affecting national and state interests. This is perhaps best explained by reference to a general cargo port. A sale or long-term lease to a private interest changes the objectives of the port. Originally developed with the interests of the hinterland in mind, the focus is then on port profits. This may not matter greatly in the short run, but changes requiring port responses to hinterland industry developments to which a government owner would normally respond in the interests of the hinterland would, if the private owner's interests are otherwise, require compensatory payments.

This clash of objectives is not resolved by lengthy and complex contracts between private and public interests. An example can be given by reference to the Melbourne Link Road, which is an important piece of infrastructure privately built and operated. Changes to the 'Existing Traffic Environment' which affect revenue will require compensation (Appendix 2.5. and elsewhere, *The Melbourne City Link Act* 1995). The Act is 405 pages long, and shifts any and all risks back to government.

This voluminous epic is an example of the problems associated with reconciling the interests of the shareholders and the public interest. The privatisation of important infrastructures requires protection of the public interest by complex contracts, which will, nevertheless, fail to achieve their objectives. This is because responses to changes in circumstances over time will require responses which are not necessarily in the asset owners interest. Government will be reluctant to make any specific compensatory payments. Capturing indirectly created benefits will not count in the private decision-making process.

For many activities associated with large pieces of major infrastructure, especially if part of an inter-connected system as in transport, problems are created by giving parts of such systems differing objectives. The above references to tunnels and toll roads indicate that the payments result in directing traffic in accordance with the revenue requirements of small bits of the system, not with what would maximise benefits for the system as a whole.

To suggest that these problems can be addressed by leasing rather than sales is simply incorrect. The leaseholder is just as interested in protecting its interests as the owner. Compensation would have to be paid for any changes required in the public interest. And the longer the lease, the greater the likelihood of technical and market changes requiring responses in the state's interest. Shorter leases invite additional conflict over the maintenance of the asset. Both types of lease have a very chequered past.

Where sales and leases of assets have had severely detrimental results in important parts of a system, such as in UK rail and California electricity, the state had to bail out the affected parts at great cost to the public. Careful attention needs to be paid to the possibility of failure and the likely costs to the state. It is important to recognise, though never mentioned, that leasing or selling important pieces of infrastructure do not allow states to avoid ultimate responsibility.

5 Conflicts of interest

Some comments of those favouring privatisation have argued the governments have a conflict of interest as being both owners and regulators of monopoly infrastructure. If governments choose to use the system for social or political ends, they will do so even when privatised. The cross-subsidisations referred to above carried on into privatisation without pause and will continue to do so.

The references above to the different objectives of private and public enterprises reflect different rather then conflicts of interest. The privatisation of some publicly-provided services may have another form of conflict of interest which can only be avoided by public provision as acknowledged by police, fire and the judiciary. The proposed privatisation of some marine piloting services in Queensland sparked a study which showed why it was, in the past, publicly provided. Because ship captains are encouraged and given incentives to complete voyages as quickly as possible, this may induce risk taking with possibly detrimental effects on other parties, including insurers, port authorities and coastal environments. Port pilots employed by companies with connections to ship owners may view risks differently, given the high daily costs of ship operation and, as a consequence, the high value of reducing voyage time.

There are other examples of actual and proposed privatisation where insufficient attention is given to the public interest in supply, consideration of which was part of the reason for deciding on supply by state-owned entities. No such investigations are proposed for current privatisation suggestions. A clear statement of how the public interest will be represented after privatisation is required, given failures elsewhere.

6 CONCLUSIONS

The current privatisation proposals are not sufficiently clearly presented to allow specific assessment. Criticism of the process to date is based on currently available information.

- No explanation has been offered for the contention that higher private costs of capital can result in lower costs and therefore lower prices.

- No explanation exists for the contention that competition between a number of suppliers of the same product using the same infrastructure will result in lower costs and therefore lower prices.

- There has been no discussion of how the owners of the privatised assets would be required to respond to changes which might over time be required in the public interest.

- There has been no statement of how the state would respond to failure of a privatised supplier of an essential service or product, as has occurred elsewhere.

- There has been no recognition of the public service obligations currently implicit or explicit in current service provision.

- The various forms of conflicts of interest which arise in the transfer of private to public ownership have received no explicit attention.

The overall conclusion is that the advantages of public ownership and the risks associated with private ownership have been completely ignored. There are considerable problems in attempting to fix what is not broken without in-depth consideration. Otherwise, privatisation reflects ideology, not economics.