To Sell or Not

***John Quiggin*, author of *Zombie Economics*, looks at the pros and cons of privatization**

SELLING public enterprises to private businesses was a central theme of economic policy in many countries during the final decades of the 20th century and in the years leading up to the global financial crisis of 2008.

Although the push for privatization took different forms in different parts of the world, it was part of a broader movement aimed at reducing the role of government in the economy and at increasing reliance on markets and prices. In particular, the movement toward privatization reflected the presumed superiority of financial markets over governments in allocating capital.

In the wake of the financial market breakdowns that characterized the global crisis, though, much of the theoretical and policy rationale for privatization has come into question. On the other hand, the adoption of austerity programs aimed at reducing public debt has led to increased focus on the sale of publicly owned assets as a way to reduce that debt, for example, in Europe.

The balance between the public and private sector is always changing, so privatization is not of itself good or bad. The only general answer to the question of whether to sell public assets is: "It depends." Before looking at the central arguments that determine the desirability of privatization in any given case, it is useful to consider the policy in its historical context.

A global phenomenon

For most of the 20th century, the range of economic activities undertaken by government generally expanded—a result both of nationalization and of the establishment of new government enterprises where private sector provision was seen as inadequate. This trend reversed toward the end of the century.

In the English-speaking world, the United Kingdom led the way in this reversal. The privatization programs of the government of Prime Minister Margaret Thatcher represented a rejection of the previous consensus on the role of government in a mixed economy, a consensus widely seen as having failed in the economic chaos of the 1970s.

In addition to selling existing assets, the Thatcher government pioneered new approaches to private provision of new public infrastructure, often referred to as public-private partnerships (PPPs). In a typical PPP arrangement, public infrastructure, such as schools and hospitals, is built and operated by private firms under long-term contracts; the associated health and education services are provided by the government.

Privatization took place on a larger scale in the last decade of the century, following the collapse of communism in Russia and eastern Europe—where all large enterprises and many small ones were publicly owned and subject, at least nominally, to central planning. The development of a market economy required the transfer of most of these enterprises to private ownership.

In the developing world, the general movement toward privatization was hastened by an emphasis on asset sales as an essential element of structural adjustment programs financed by the IMF and other international agencies.

The pace of privatization slowed in the 2000s, as governments ran out of easily salable assets and problems with earlier privatization emerged.

Perhaps the most striking examples of those problems were in the United Kingdom. Following a series of serious train accidents and ongoing questions about safety and performance, the government renationalized Railtrack, the privatized owner of the nation's

rail network. A few years later, the partial privatization of the London Underground network, through a PPP arrangement, was plagued by mismanagement in one of the private companies responsible for operating the subway. Like the rail network, the London subway was renationalized. More recently, the U.K. Private Finance Initiative, responsible for PPPs at the national level, has come under severe criticism from members of Parliament, including government ministers.

The appeal of infrastructure built with no apparent cost to the public has been replaced by the reality of the need to service a large debt at the rates of return demanded by private investors in such projects—usually substantially higher than government bond interest rates.

A temporary reversal

A big reversal in the trend toward privatization occurred immediately after the global financial crisis began in 2008. Banks in the United States and Europe were rescued by their national governments on terms that amounted to nationalization, either implicitly or explicitly. Interestingly, some of these same banks had been leading advocates of privatization, which a number continued to support even when they were in public ownership. The process went beyond banks in the United States, where General Motors, long emblematic of private enterprise, was temporarily nationalized to prevent its failure.

With the emergence of sovereign debt problems as a central policy concern, however, privatization is back on the agenda. Selling assets seems to be an easy way for governments to raise cash. Meanwhile, economic arguments about the costs and benefits of private and public ownership remain unresolved, and have been further complicated by the challenges to economic theory posed by the financial crisis.

While there are many arguments for and against privatization in particular cases, in general the most common argument for privatization is that it provides hard-pressed governments with a source of ready cash. But this argument is not as clearcut as it might seem. Selling an asset yields an immediate financial benefit, but it requires governments to forgo the earnings or services the asset would otherwise have generated.

The obvious question is whether the proceeds from selling an asset are more or less than the value of the earnings forgone. In principle, this is a straightforward question. We can look at the amount of interest saved if the proceeds from the sale were used to repay public debt and compare those savings to the earnings that would be generated under continued public ownership. Alternatively, but equivalently, we can convert a projected stream of future earnings into a present value, discounted at the rate of interest on public debt. If the proceeds from the sale exceed the present value of forgone earnings, privatization has improved the government's fiscal position.

There are two factors that will determine the outcome of an exercise of this kind:

First is *the operational efficiency of the firm under private and public ownership*. In general, a firm operating in a competitive market will do better under private ownership. However, if the market requires extensive regulation—to deal with monopoly or externality problems—the advantages of private ownership are diminished and may disappear.

Second is *the relative cost of capital, taking appropriate account of risk*. In general, even after allowing for default risk, governments can borrow more cheaply than private firms. This cost saving may or may not outweigh the operational efficiency gains usually associated with private ownership.

Still, it remains relatively rare to see privatization subjected to this simple empirical test. I have analyzed a number of Australian and British privatizations of the 1980s and 1990s and found that very few of them increased public sector net worth (Quiggin, 1995; 2010). The privatizations undertaken by the Thatcher government, widely applauded at the time, were among the worst in terms of their effects on the net worth of the public sector. Most notable was the sale of 50 percent of British Telecom for a mere £3.7 billion, at a time when its pre-tax earnings were about £2.5 billion a year.

Public sector suffers

There are a number of reasons why privatizations have left public sector net worth less well off. In some cases, including that of British Telecom, governments have deliberately underpriced assets for political reasons. Particularly in the case of a public sale of stock in an enterprise, governments often want to ensure that the share issue is fully subscribed and that buyers do not lose money through a decline in the share price. Both these incentives lead to underpricing.

Notting Hill Gate Underground station, London, England.

Worse still, as in parts of the former Soviet Union, are cases in which the privatization process was corrupted. In many cases, small numbers of people have gained control of vast assets, while the public got little in return. Cases of this kind pose a sharp dilemma. On the one hand, it is undesirable to have public assets operated by a corrupt and unaccountable government. On the other hand, when such governments are put in charge of the sale of public assets, even larger losses accrue all at once.

But even where governments are motivated to seek the full market price for public assets, the benefits of lower debt often fail to match the cost of forgone earnings. The problem is that investors generally demand a substantially higher return on equity capital than on the high-grade debt issued by governments. This differential—called the *equity premium*—cannot be explained simply by the fact that returns on equity are riskier. Twenty-five years of analysis of the so-called equity premium puzzle has failed to produce a fully satisfactory explanation for its existence.

In most sectors of the economy, the higher cost of equity capital is more than offset by the fact that private firms are run more efficiently, and therefore more profitably, than government enterprises. But enterprises owned by governments are usually capital intensive and often have monopoly power that entails close external regulation, regardless of ownership. In these situations, the scope to increase profitability is limited, and the lower value of the asset to a private owner is reflected in the higher rate of return demanded by equity investors.

When it makes sense

Sometimes the sale of public assets as a way to raise revenue makes sense.

First, like all large organizations, *governments have changing goals and objectives. Assets that were useful in one context may be superfluous in another*. For example, as the U.S. military has become smaller and more professional, the need for army bases has declined, and some have been closed and sold. Rational asset management makes sense regardless of views about privatization and public ownership.

Second, *some enterprises are unprofitable under public ownership, perhaps because of political constraints on such matters as hiring and firing, but can be sold to private investors who are not subject to these constraints*. In cases of this kind, there is a clear fiscal benefit. However, it is important to consider whether the constraints in question are inherent in public ownership and whether the question of structural reform can be separated from that of private or public ownership.

Finally, *if a government is in such dire straits that it can no longer borrow at the prevailing low rates for high-quality public debt, often it makes sense to sell income-earning assets*. The interest saved is more than the earnings forgone. In cases of this kind, privatization may take place at fire-sale prices—not an optimal outcome. A preferable alternative is for international lenders such as the IMF to provide liquidity while efficient adjustments (including asset sales where these pass the benefit-cost test) are undertaken.

In general, however, the idea that governments can improve their financial position to any significant degree by selling assets is an illusion arising from a focus on accounting numbers rather than economic realities. The economic argument for privatization is that it will lead to more socially efficient provision of goods and services, more competitive markets, and greater responsiveness to consumer needs and preferences. The strength of this argument, and of counter-arguments based on market failure, varies from case to case.

The strongest case for privatization arises in the wake of rescues like that of General Motors in the United States and, several decades earlier, of Rolls-Royce in the United Kingdom. Firms like these, operating in competitive markets and with no particular need for regulation, never belonged in the public sector. In the ordinary course of events, faced with severe financial difficulties, they would have gone out of business. However, given their iconic status, governments were willing to risk public money to keep them going. In both these cases, the rescue was successful and the firms were returned to private ownership.

No competition

At least in the developed world, however, such cases are rare. Most cases of public ownership across developed countries reflect the lack of many goods and services in competitive markets or special characteristics that require regulation. Infrastructure services of various kinds are commonly subject to public ownership. There are several reasons for this:

- These enterprises are usually capital intensive, so the low cost of public sector borrowing is more important.
- Infrastructure services are typically natural monopolies—a given area needs only one electricity network, water supply system, and so forth. This means that, even under private ownership, extensive regulation is needed, so the choice is between one form of government intervention and another.
- In many cases, such as that of road networks, it is difficult or impossible to impose prices that reflect the true social cost of provision.

Still, the temptation to move costly infrastructure investments off the books has proved irresistible for many governments, most notably in the case of toll roads. While toll road projects look good in an accounting sense, they are often failures in economic terms. The risk associated with owning just one part of a large road network means that private investors demand high returns. The cost of a toll road project, as measured by the discounted present value of toll revenue, is typically as much as twice the cost of a similar road financed by public debt and serviced by gasoline taxes or other indirect road user charges.

Moreover, the pattern of prices associated with toll roads is usually the opposite of what would be indicated by economic analysis. The primary cost of using a specific road is the resulting increase in congestion, which is why economists support congestion charges such as those imposed in central London. But, as in the case of London, it is typically the oldest roads that are most congested. Imposing a toll on a new, and uncrowded, road often increases the flow of traffic on older, more congested roads, reducing and sometimes wiping out the net benefits of the road project.

Health and education

Separate concerns arise with services such as health and education. For various reasons, these services are funded primarily by governments and provided either by public institutions or by private (often religiously based) nonprofit organizations. For-profit provision of health and education services has generally been problematic and, in the case of education, almost uniformly unsuccessful.

The problem in these cases is that there is no real market. The patients and students to whom health and education services are provided rarely pay directly for the services they consume. Instead, providers operate in pseudo markets created by governments and insurers. In this context, the sharp focus on profitability associated with private ownership works not to meet consumer need, but to seek out opportunities to game the system. For-profit health providers often engage in cost shifting, focusing on high-return services while pushing costly cases over to the public sector. For-profit higher education providers can exploit the weakness of student grant and loan systems.

Given the weakness of market incentives, only organizations with a strong ethic of professional service can provide high-quality services such as health and education. But such an ethic cannot be wished into existence, and it rarely works perfectly; it is almost impossible to maintain a service ethic while at the same time using managerial controls to increase efficiency. Nevertheless, experience suggests that there is no alternative.

The strongest case for privatization arises in the wake of rescues like that of General Motors in the United States and, several decades earlier, of Rolls-Royce in the United Kingdom.

Technologies and social priorities change over time, with the result that activities suitable for public ownership at one time may be candidates for privatization in another. However, the reverse is equally true. Problems in financial markets or the emergence of new technologies may call for government intervention in activities previously undertaken by private enterprise.

In summary, privatization is valid and important as a policy tool for managing public sector assets effectively, but must be matched by a willingness to undertake new public investment where it is necessary. As a policy program, the idea of large-scale privatization has had some important successes, but has reached its limits in many cases. Selling income-generating assets is rarely helpful as a way of reducing net debt. The central focus should always be on achieving the right balance between the public and private sectors. ■

John Quiggin is a Professor of Economics at the University of Queensland.

References:

Quiggin, John, 1995, "Does Privatization Pay?" Australian Economic Review, *No. 110 (2nd quarter), pp. 23–42.*

———, *2010,* Zombie Economics: How Dead Ideas Still Walk Among Us *(Princeton, New Jersey: Princeton University Press).*