WHY IS PRIVATISATION SO CONTROVERSIAL?

Privatisation is controversial despite empirical studies showing it is a highly successful policy, says **Sinclair Davidson**

The spectre of privatisation is haunting both Australia and New Zealand. The centre-right Key government in New Zealand has encountered substantial opposition to the partial privatisation of electricity utilities, while the newly elected centre-right Abbott government in Australia had ruled out privatising the Australian Broadcasting Corporation before the election. In January, the Abbott government also ruled out privatising Australia Post after comments from Australian Competition and Consumer Commission (ACCC) chairman Rod Sims were widely reported as proposing that policy.

Privatisation is politically unpopular; according to polling undertaken by Essential Media, most Australians (58%) are opposed to privatisation with only 22% thinking the policy is a good idea.[1] In an earlier poll, Essential Media had found that only 6% of respondents thought the public had benefitted from past privatisations.[2] On the other hand, we know that privatised firms 'almost always become more efficient, more profitable, and financially healthier, and increase their capital investment spending.'[3]

The problem is that privatisation is controversial despite empirical studies showing that it is a highly successful policy. In this essay, I set out arguments why privatisation is politically unpopular despite its track record of success, and the dangers associated with the need for government to privatise.

Why the controversy?

Privatisation is defined as the transfer of ownership rights in state-owned enterprises to the private sector. This type of activity has taken place throughout history, but it has become controversial in the post-war era. The first (modern) Australian privatisation, that I am aware of, is the sale by the Commonwealth government of its half-share of the Commonwealth Oil Refinery to the then Anglo-Iranian Oil Company (now British Petroleum) in 1952.[4] The then opposition opposed the sale saying the price was too low, that it would undermine national security, and the like.[5] The arguments opposing privatisation have not changed much since, and we still hear those justifications for government involvement in the private economy.

To use Thomas Sowell's terminology, there exists a conflict of visions in the privatisation debate between statist propaganda that citizens have been exposed to over long periods of time and the lived experience. The lived experience is that privatisation as a policy has been successful, while the propaganda goes to the core of political debate. Privatisation as a policy raises questions about the role and function of the state generally and, in particular, the role of the state in the economy.

The way to best understand the issue is to consider a two-by-two matrix. Ask whether private solutions are possible for most societal problems, and ask whether public solutions are possible for most societal problems (Figure 1).

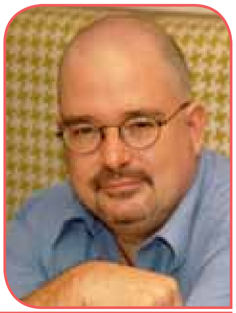

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Figure 1: Why is privatisation controversial?

		Private solutions: Yes	Private solutions: No
Solution	Yes	Elite opinion	Statist
Solution	No	Free marketeer	Malcontent

As the matrix in Figure 1 shows, there is an overlap between the two positions—it is possible for individuals to believe that the private sector or the public sector can be equally good at resolving some issues. That quadrant I have labelled 'Elite opinion'; it is also the opinion of most economists. 'Statists' believe the public sector is capable of resolving societal problems but the private sector is not. The 'Free Marketeers' believe the private sector is capable of resolving societal problems but the public sector is not. Finally, the 'Malcontents' believe that neither the public sector nor the private sector is capable of resolving societal problems.

Privatisation is a controversial policy for everyone except the 'Free Marketeers.' Individuals in the other three quadrants are being asked to relinquish deeply held or even cherished views. Even individuals within the 'Elite opinion' quadrant—where most professional economists are likely to reside—are being invited to believe that the public solutions do not out-perform private solutions.

Privatisation is likely to interact poorly with at least three of Bryan Caplan's four voter biases[6] that lead democracies to make poor economic decisions. Anti-market bias underestimates the economic benefits of markets. Anti-foreign bias undervalues interactions with foreigners. The make-work bias undervalues labour conservation (or productivity improvements). Finally, the pessimism bias overestimates the severity of economic problems.

Criticisms of privatisation often revolve around the employment consequences and selling national icons to foreigners. By definition, privatisation is making use of the market mechanism. Those voters who suffer from Caplan's biases are likely to oppose privatisation.

While sophisticated elites may not be biased, they tend to be rationalists in the Hayekian sense. The question they are likely to ask is: 'Why shouldn't government ownership work just as well as private ownership?' This question is at the heart of the socialist calculation debate that raged in the 1930s[7] on whether a socialist economy could replicate the performance of a capitalist economy, and whether a socialist economy could outperform or improve upon the outcomes of a capitalist economy. Until the late 1980s, many economists would have argued that a socialist economy could improve upon the outcomes of a capitalist economy.[8] Economists such as Joseph Stiglitz continue to hold, even after the collapse of the Berlin Wall, that government can outperform private enterprise.[9]

Similarly, as I explain in the next section, there are good theoretical reasons for believing that state-owned enterprise can perform as well as private enterprise, if not better.

While every economist is trained in the market failure literature, most are not familiar with the counterarguments as articulated by Ronald Coase and Harold Demsetz.

Arguments in favour of state-owned enterprise

The theoretical arguments for state-owned enterprise are superficially compelling for four reasons.

The standard market failure literature suggests that markets will misallocate resources due to factors such as natural monopoly, various externalities, and asymmetric information. In this framework, government can intervene and improve upon the allocation of resources, leading to superior outcomes than private outcomes. Such logic gives rise to the Sappington and Stiglitz fundamental theorem of privatisation—that privatisation should only occur when the market would perform as well as a benevolent government.[10]

That has led William Megginson to remark that if governments were benevolent, there would be no need for them to privatise.[11]

While every economist is trained in the market failure literature, most are not familiar with the counterarguments as articulated by Ronald Coase and Harold Demsetz. Often, economists think it enough to point to some apparent market failure without considering whether government intervention will improve on those outcomes.

A subtler argument relates to the so-called equity-risk premium. Some economists argue that real-world equity markets are associated with imperfections that result in the required rates of return being higher than they otherwise should be.[12] There are practical consequences to what would otherwise be an esoteric academic debate. If government did not have to pay those higher rates of return on its cost of capital, then state-owned enterprises could enjoy a lower cost of capital than their private sector counterparts. As Simon Grant and John Quiggin explain:

> *If there is no efficiency loss associated with public ownership*, the expected marginal return to public investment … dominates the expected marginal return to private equity … an expansion of public investment is desirable.[13] [emphasis added]

> It is clear that the Grant-Quiggin view violates the Modigliani-Miller theories of corporate finance.

At face value, that seems to be a powerful argument: as long as government ownership *per se* doesn't affect efficiency, government ownership can be cheaper than private ownership. When stated in those terms, however, it is clear that the Grant-Quiggin view violates the Modigliani-Miller theories of corporate finance. The cost of capital is a function of the riskiness of the investment projects and not a function of a firm's ownership structure. A better understanding of those theories would have prevented much of the confusion that surrounded the 2010 mining tax proposals. In any event, government ownership is likely to affect efficiency and there are no free lunches.

There are two lesser-known arguments in favour of state-owned enterprises. They can be used to pursue social objectives such as employing minorities or undertaking investment in remote areas, and government can overcome principal-agent problems by better controlling management than diverse and dispersed shareholders.

To be sure, there are counterarguments to these points—as I have indicated. Yet the point is that in-principle arguments in favour of state-ownership are plausible and, at face value, seem reasonable. It is the empirical record that is decisive. Megginson—the foremost academic expert on privatisation—has summed up that empirical record as follows:

> Almost all studies that examine post-privatization changes in output, efficiency, profitability, capital investment spending, and leverage document significant increases in the first four and significant declines in leverage.[14]

Andrei Shleifer, et al. have examined the consequences of government ownership in the banking and media industries.[15] In both industries, there are plausible arguments for maintaining high levels of government ownership. Here in Australia, for example, we are familiar with the notion that state-owned media enterprises promote a better-informed population as they promote less-biased and provide more complete information than the private sector, at least in theory. This is known as the public interest theory of government ownership.

By contrast, public choice theory posits that government ownership exists to allow political elites to divert resources to narrow interest groups, or to distort and manipulate information to benefit and entrench those elites. After careful analysis of a large cross-section of countries, including Australia, Shleifer, et al. report that the evidence tends to support the public choice interpretation over public interest explanations for government ownership. As Megginson says: 'Private ownership must be considered superior to state ownership in all but the most narrowly defined fields or under very special circumstances.'[16]

In light of the empirical evidence, it would appear that all governments with significant state-owned assets should pursue a policy of privatisation. Yet that is not the case. To some extent this is the victory of the 'Malcontents'—those individuals who can never be pleased with any policy, even when the evidence overwhelmingly suggests that the policy is successful.

The need for a fiscal constitution

In an analysis of 34 economies (including Australia) over the period 1977–99, Bernardo Bortolotti, Marcella Fantini, and Domenico Siniscalco report that countries that tend to pursue privatisation policies have 'right-wing' governments and have high levels of public debt.[17] As they say, 'Fiscal imbalances trigger privatisation, as the windfall revenue can be used to square public finances.'[18] The Grattan Institute shows that the Howard government raised just over $40 billion from privatisation receipts from 1996 to 2001, and reduced public debt by just under $60 billion from 1997 to 2002.[19] This sounds sensible as a justification for privatisation, with even Roger Kerr of the former New Zealand Business Roundtable noting that this was a valid, if secondary, argument in favour of privatisation.[20] The problem is that public assets are a finite resource, while governments' capacity to generate deficit and debt is infinite. Having said that, Infrastructure Australia estimates there are about $100 billion worth of state government assets that could be privatised.[21]

Selling public assets to pay for past irresponsible government spending sprees may get economies out of debt and deficit holes now, but without a fiscal constitution that restrains future debt and deficit the underlying problem remains. The problem is neatly described by John Roskam:[22]

> Conservatives in Australia have for too long prided themselves on their self-image as the side that gets into government and then cleans up Labor's mess. But there's little nobility in washing the dishes after the chef has cooked the feast. A more accurate description of what state and federal Coalition governments do after Labor governments is that conservatives find the way to pay for the promises of their political opponents.

Privatisation to pay off public debt to validate past consumption is a case of eating seed capital.

This isn't an argument against privatisation; as Roger Kerr emphasises, the benefit of privatisation is increased efficiency. Yet privatisation does allow politicians to postpone difficult decisions. Most Western economies have large budget deficits and massive public spending problems. James Buchanan has long argued that majority rule is not a sufficient constraint on excessive public spending, high taxation, and borrowing.[23] To that end, he and Richard Wagner have suggested the need for a fiscal constitution or a return to the 'old time fiscal religion' of balanced budgets.[24]

Selling public assets to pay for past irresponsible government spending sprees may get economies out of debt and deficit holes now, but without a fiscal constitution that restrains future debt and deficit the underlying problem remains.

The problem is that governments don't privatise to improve economic efficiency and performance, but rather when they need the money to pay off debt. It isn't good enough to argue that it doesn't matter why government privatises, as long as it does privatise. The bigger distortion to the economy isn't that government still owns some firms, but rather that government continues to live well beyond its means and spends too much money.

Conclusion

The empirical evidence overwhelmingly shows that private ownership results in superior outcomes to public ownership. This statement may not be always true but there are few certainties in life. But it is true enough that there should be a strong policy bias towards privatisation and against state ownership.

Based on these arguments why the public may be less enthusiastic about privatisation given its policy success, it may well be that politicians can only sell the idea to a sceptical electorate during a budget crisis. Nonetheless, state-owned enterprises that can be sold off to pay for poor spending decisions are a non-renewable resource and the electorate is going to have to start keeping a closer eye on public spending if it remains unwilling to pay higher taxes.

Endnotes

1 Essential Media, Essential Report (11 March 2013).

2 Essential Media, Essential Report (14 November 2011).

3 William Megginson and Jeffry Netter, 'From State to Market: A Survey of Empirical Studies on Privatization,' *Journal of Economic Literature* 39:2 (2001), 381.

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6 Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies*, Policy Analysis No. 594 (Princeton University Press, 2007).

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11 William Megginson, *The Financial Economics of Privatization* (Oxford University Press, 2005), 96.

12 Rajnish Mehra and Edward C. Prescott, 'The Equity Premium: A Puzzle,' *Journal of Monetary Economics* 15:2 (March 1985), 145–161.

13 Simon Grant and John Quiggin, 'Public Investment and the Risk Premium for Equity,' *Economica* 70:277 (2003), 14.

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15 Rafael La Porta, Florencio Lopez-de-Silanes, and Andrei Shleifer, 'Government Ownership of Banks,' *The Journal of Finance* 57:1 (2002), 265–301; Simeon Djankov, Caralee McLiesh, Tatiana Nenova, and Andrei Shleifer, 'Who Owns the Media?' *Journal of Law and Economics* 46:2 (2003), 341–381.

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18 As above, 306.

19 John Daley, 'Balancing Budgets: Tough Choices We Need,' *The Grattan Institute* (2013), 87.

20 Roger Kerr, 'The truth about privatisation: Blog #5' (2011).

21 In John Daley, 'Balancing Budgets: Tough Choices We Need,' as above, 79.

22 John Roskam, 'Burn the boats and ditch the life raft,' *The Australian Financial Review* (3 May 2013).

23 See, for example, Geoffrey Brennan and James Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution* (Liberty Fund, 1980).

24 James Buchanan and Richard Wagner, *Democracy in Deficit: The Political Legacy of Lord Keynes* (Liberty Fund, 1977).

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