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# Chapter 1

## Introduction

Privatization policies are currently in progress the world over—in Europe, North America, Japan, and numerous developing and newly industrialized countries—but nowhere are they being carried out as vigorously and extensively as in Britain. When Mrs Thatcher came to power in 1979, about 11.5 percent of gross domestic product was accounted for by state-owned enterprises. By the time of her third election victory in June 1987, that figure was down by over a third to about 7.5 percent. In the process over half a million employees were transferred to the private sector, of whom around 90 percent acquired shares in their companies, and the total number of private shareholders in Britain roughly trebled. And much more is to come.

Privatization, then, is high on the political agenda, but what of its economic consequences? Answers to this question are as old as the subject of economics itself. In the *Wealth of Nations* Adam Smith (1776) argued that:

“In every great monarchy in Europe the sale of the crown lands would produce a very large sum of money, which, if applied to the payment of the public debts, would deliver from mortgage a much greater revenue than any which those lands have ever afforded to the crown . . . . When the crown lands had become private property, they would, in the course of a few years, become well improved and well cultivated.”

This view of the issue has not gone uncontested. Apart from the Marxist critique of private ownership of the means of production, it is perfectly possible to argue within an orthodox microeconomics framework that in many contexts (of which natural monopoly conditions are the most obvious example) public management will do better in terms of economic efficiency than private management.

Despite the long history of debate, it would be wrong to conclude that the issue of ownership has occupied a central place in the development of economic analysis. On the contrary, although there have been a number of distinguished contributions to the subject, mainstream economic theory has tended to bypass the issue: most microeconomics textbooks, for example, contain little or no discussion of *positive* theories of public enterprise. This might be considered a somewhat surprising outcome in view of the prominence frequently afforded to the question of ownership in political life: differences in attitudes to public and private ownership are frequently some of the main distinguishing characteristics of political

parties. It may, however, simply be a reflection of beliefs either that the ownership of firms is a factor of relatively little economic importance and/or that public policy in this area is influenced much more by political philosophy and political expediency than by the niceties of economic analysis.

Our own view is that both the latter beliefs are misguided. In the first place, there are good reasons for thinking that the ownership of a firm will have significant effects on its behavior and performance, since changes in property rights will alter the structure of incentives faced by decision makers in the firm. Second, although economic analysis may have little direct impact on particular policy decisions, it does, over time, affect the climate of public opinion within which those decisions are made. Keynes (1936) was no doubt (deliberately) exaggerating the position when he claimed that "Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist," but it is not necessary to go this far to believe that ideas, analysis, and evidence do, ultimately, have a substantive bearing on the evolution of public policy.

Apart from the obvious and important point that extensive privatization programs are under way in many countries, we would argue that, for at least two further reasons, now is a particularly timely moment to re-examine the implications of the structure of ownership for the behavior and performance of firms. First, over the past decade there have been a number of important advances in areas of economic theory that are of immediate relevance to the ownership question, including the study of principal-agent relationships, imperfect competition, and regulatory theory. Second, technological and structural changes in a number of industries where public ownership is common indicate that a re-evaluation of policy options is in order.

It is these three factors—the significance of current privatization policies, developments in economic analysis, and technological and structural change—that motivate our book. The 11 chapters that follow are divided into two major parts. Part I (chapters 2 through 4) presents a number of theoretical perspectives on the topics of ownership, competition, and regulation, which have a direct bearing on the issue of the relative performance of publicly owned and privately owned firms, while part II (chapters 5 through 11) aims to give a comprehensive assessment of the privatization policies that were implemented in Britain between the summer of 1979 and the autumn of 1987—a period that approximately coincides with the first two Thatcher Governments.

We commence, in chapter 2, with the question: does ownership matter? The analysis is concerned chiefly with the effects of ownership on allocative efficiency in the marketplace and on the internal efficiency of firms. We conclude that the allocation of property rights does matter because it determines the objectives of the "owners" of the firm (public or private) and the systems of monitoring managerial performance. Public and private ownership differ in both respects. As a result, changes in property rights will materially affect the incentive structures, and hence the behavior, of managements.

The efficiency implications of these changes in incentives depend very much upon the competitive and regulatory environment in which a given firm operates. Indeed, it can be argued that the degree of product market competition and the effectiveness of regulatory policy typically have rather larger effects on performance than ownership *per se*. Chapters 3 and 4, therefore, are respectively devoted to evaluations of the roles played by competitive forces and regulation in determining managerial incentives, behavior, and performance.

With respect to competition we stress three themes: the role of potential competition, the properties of product market competition when viewed as an incentive mechanism, and competition issues that arise in connection with networks and vertical relationships. These themes have been selected because of their importance to the ownership question in general and to the British privatization program in particular. In each case, we are primarily interested in the relationships between market structures and economic efficiency.

In chapter 4 we seek to provide a theoretical perspective on the economics of regulation that will underpin our assessment of British regulatory policy in part II of the book. Regulation is viewed as a game between the policy agency and the firm(s), and the focus is on the incentive properties of various regulatory mechanisms to encourage both internal and allocative efficiency. As a consequence of imperfect information, there is necessarily a trade-off between the two components of efficiency and we examine ways in which this trade-off can be handled. Other issues that are emphasized include the dynamics of regulation and the strategic interactions between firms and regulators that can occur over time.

Since the British privatization program has partly been motivated by dissatisfaction with the economic performance of publicly owned firms, and since we need to establish benchmarks against which the records of newly privatized firms can be judged, part II of the book begins, in chapter 5, with an examination of the framework of control for nationalized

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industries in Britain, together with an assessment of the past performance of these industries.

In chapter 6 we move on to present an overview of the British privatization program. We argue that, although a number of policy objectives have been set forth in connection with the program, many of the stated goals (e.g. wider share ownership) could better be attained by means of alternative policies and, therefore, that privatization policies should primarily be judged on their contribution to economic efficiency. Chapter 7 examines some financial aspects of the sale of state assets.

While the smaller asset sales are assessed, albeit briefly, in chapter 6, the larger privatizations are singled out for much more extensive evaluations in the later chapters of the book. For convenience, these are grouped according to industrial sector: telecommunications (chapter 8); energy (chapter 9); transport (chapter 10); and water (chapter 11). Under these headings we take the opportunity to discuss planned privatizations (electricity and water) and possible future privatizations (e.g. coal and rail transport), as well as the asset transfers that have already taken place.

In each case, we first outline the main characteristics of the industry or industries concerned and then proceed to evaluate the policy changes that have recently been implemented or are planned for the near future. A number of themes emerge that are common to several of the chapters, including the role of new entry and potential competition, the network characteristics of the various industries, and the similarities among the regulatory structures and policies that have been adopted or are proposed. The common themes serve to link the case-by-case evaluations back to the theoretical perspectives developed in part I of the book.

In chapter 12 we conclude by drawing together the various threads of argument to give an overall assessment of the British privatization program. We stress the lessons that it contains for the future development of economic policy, including the importance of increasing effective (actual or potential) competition and improving the longer-term effectiveness of regulatory policies to contain monopoly power.

We began by quoting Adam Smith's advocacy of the sale of the crown lands (and note that farming is a competitive business). We will end by giving another quotation from Adam Smith which also bears on a central theme of this book:

"Monopoly, besides, is a great enemy to good management, which can never be universally established but in consequence of that free and universal competition which forces every body to have recourse to it for the sake of self-defence."