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Conclusions

“Suppose a schoolboy was asked to observe the sale of British Gas and then explain the meaning of the term privatisation. What sort of an account would he give? His first intelligent guess might be that it was some kind of stunt organised by the advertising profession. What else could explain the frequency of the TV advertisements featuring his favourite soap opera stars or the number of colourful hoardings in city centres?

But then he might observe his parents raiding the building society and pleading with the bank manager to lend them money. He would deduce that privatisation was a serious matter involving something called ‘investment.’ What you do is send off a cheque and await what appears to be a guaranteed profit. Then you may well sell your shares as quickly as possible.

The boy, if really bright, would realise that privatisation also entails a change in status of a large and powerful company. Yet it is a change which seems to have few material consequences: the company does not get split up or experience a change in management. The crucial thing is that the process of ‘going into the private sector’ seems to make the chairman, government ministers, a place called the City and his parents very happy. It brightens up Christmas.

What the child would never guess is that privatisation is supposed to be a way of improving industrial efficiency.”

(Financial Times editorial, 26 November 1986)

The British privatization program has been widely acclaimed as an economic and political success of the first order. It has led to a massive expansion in the number of shareholders, billions of pounds have been raised for the Exchequer, and state involvement in industrial decision making has been drastically reduced. But has the British privatization program really been a success? What lessons does it hold for the longer term?

To assess these questions we must first specify criteria for judgment. In this book we have taken the improvement of industrial efficiency to be the primary criterion. Many other goals have been associated with the privatization program—extending share ownership, raising revenue, and so on—but those objectives can be promoted more sensibly by other means, and we therefore attach only secondary importance to them. (However, as we have seen in the last few chapters, the Government’s ranking of priorities seems to have been otherwise.)

We have stressed in this book that the economics of privatization cannot be separated from the economics of competition and regulation. Ownership arrangements—including shareholder monitoring and the possibilities of takeover and bankruptcy—are an important influence upon the incentives of decision makers in firms, but their behavior depends equally upon the stimulus of market forces and mechanisms of regulation. As well as its direct benefit in promoting allocative efficiency, competition between firms has the added advantage of improving internal efficiency by enabling managerial incentive structures to be based on comparative performance measurement. Competition serves to overcome asymmetries of information between owners and managers, and thereby diminishes inefficiency and slack. Despite these advantages, head-to-head competition can at times be wasteful and inefficient, for example when there are large scale economies or externalities between firms. Even so, potential competition in the form of entry threats or competition induced by regulatory mechanisms (e.g. franchising or yardstick regulation) can still play an important role in promoting allocative and internal efficiency.

Because ownership, competition, and regulation are such interrelated determinants of corporate incentives and behavior, it is impossible to assert very general propositions as to the respective merits of private and public ownership. Theoretical analysis and empirical evidence support the view that private ownership is most efficient—and hence privatization is most suitable—in markets where effective (actual or potential) competition prevails. Thus in the British privatization it was sensible to focus initially on companies such as Amersham, British Aerospace, Cable and Wireless, Enterprise Oil, and Jaguar, all of which operate in reasonably competitive conditions. In those cases the conflict between objectives that would become a feature of later privatizations did not emerge, because the discipline of market forces serves to channel private energies toward socially desirable ends.

Policy dilemmas became sharper when the Government's ambitions to privatize grew to embrace firms with extensive market power. Where monopoly exists—that “great enemy to good management” in Adam Smith's words—the case for preferring private ownership to public ownership weakens considerably: privately efficient profit seeking can no longer be expected to lead to socially efficient results. It is then imperative for privatization, if it occurs, to be accompanied by adequate measures to reduce and contain market power. Where feasible, the scope of competitive forces (actual or potential) should be expanded by the effective removal of barriers to entry and by restructuring the dominant enterprise. Where

monopoly power still remains, the task is to devise regulatory mechanisms that encourage internal and allocative efficiency and discourage strategic behavior by the firm towards the regulatory authority. That can best be done if the firm's monopoly of information is broken, and the regulator has independent access to detailed information bearing on, for example, the potential for cost reduction and the relative costs of different services supplied by a multiproduct firm. Unless effective competition and/or regulation are introduced, the privatization of firms with market power brings about private ownership in precisely the circumstances where it has least to offer.

We have seen in the later chapters of this book that British privatization policy for firms with monopoly power (e.g. British Telecom (BT) and British Gas) has been seriously flawed. Important obstacles to competition have been left in place and, even where legal barriers to entry have been removed, mechanisms to guard against anticompetitive behavior are often weak (though Oftel has made strenuous efforts in this regard). The desire to limit the burden on regulators has often resulted in limiting the effectiveness of regulation. For example, the information available to Ofgas about the business of British Gas is minimal. RPI - X price regulation has been introduced in several industries (telecommunications, gas, and airports to date) to hold the fort for the time being, but it leaves wide discretion to the regulated firms (e.g. regarding relative prices) and its longer-term efficiency properties are questionable unless the authorities have access to independent information of good quality. The energetic activities of Oftel in price regulation underline this point about information, and show the importance of a regulator going beyond the simple remit that RPI - X lays down. However, nothing requires Oftel to adopt the active pro-competitive stance that it has taken. The effectiveness of regulation in the future will depend heavily upon the attitudes that regulatory bodies, the Monopolies and Mergers Commission and government ministers choose to adopt.

Although the main focus of regulatory activity is on pricing, we have emphasized in several chapters the importance of regulatory incentives for investment behavior. Whereas much of the theoretical literature has examined strategic motives for overinvestment, we have examined several dangers of underinvestment. First, private discount rates may substantially exceed social discount rates, especially in view of uncertainty about the future of regulation (existing regimes specify little beyond their initial five-year term) and longer-run political developments. Secondly, it is difficult for governments to commit their successors to allow the regulated

firm its fair share of the gains from successful investment and innovation, and hence dynamic efficiency may suffer. These concerns are greatest in industries with long asset lives and sunk costs (e.g. water and gas pipelines).

Thus there are several grounds for concern about the prospects for the long-term industrial performance of the major privatized firms. Some difficulties (e.g. political uncertainty) are not within the Government's control, but their policies on competition and regulation have been faulty in many instances. In our view, Mrs Thatcher's Government has been guilty of just the sort of "short termism" that has colored policy toward nationalized industries in the past. The desires to privatize speedily, to widen share ownership quickly, and to raise short-term revenues have stood in the way of devising adequate measures of competition and regulation for the industries concerned. (In the event revenues have not been maximized either because of the underpricing of shares.) In the process, the Government has partly been captured by the managements of the firms being sold, since their cooperation is essential for rapid privatization. Short-term political advantage may have been won, but longer-lasting gains in economic efficiency have been lost.

In criticizing the Government's policies for competition and regulation in the privatization program, we do not wish to suggest that there are easy alternative solutions. On the contrary, the problems of organization and control in utility industries such as telecommunications, gas, electricity, and water are among the most difficult in the field of microeconomic policy. Indeed, our view is that under private ownership there are conditions in which they become so acute that public ownership is to be preferred. When there are massive economies of scale and scope, high entry barriers, or externalities, private ownership performs poorly. The incentive and opportunity to exploit consumers threatens allocative efficiency, and the lack of competitive benchmarks leads to internal inefficiency and slack. The fact that public ownership is also far from perfect in these circumstances reflects the inherent difficulty of economic organization in such industries.

The final question is whether it was right to sell the companies that have been privatized and whether it is desirable to press on with the privatization program. This question cannot properly be answered independently of the mechanisms of competition and regulation for the industries concerned (whether they are in public or private ownership), but our broad views are as follows. Privatization is appropriate where private ownership works best, and we therefore agree with the privatization of firms in reasonably competitive industries, including Amersham, Associated British Ports,

British Aerospace, British Petroleum, Cable and Wireless, Enterprise Oil, Jaguar, Rolls-Royce, and the TSB. Likewise, British Airways should be in private ownership provided that it is made to operate in a truly competitive environment. As to the future, there are good grounds for selling remaining state holdings in the car and steel industries if that becomes feasible.

In the utility industries we believe that a more piecemeal approach is warranted. Competition and private ownership are more suitable for BT's long-distance and apparatus supply businesses than for its local network operations. In the gas industry we believe that privatization would have been more advantageous if the national transmission system had been kept under public ownership. Regionalization of the area boards, and the privatization of some of them, would have allowed yardstick regulation and a direct comparison of public and private performance. Similarly, in the electricity supply industry, we would not privatize the national transmission grid. Nor do we favor the privatization of nuclear power stations, but we do not believe that the privatization of some other generating capacity would be a bad thing, provided that effective environmental regulation exists. As in gas, the regionalization and the privatization of some area electricity boards is an option with attractions.

In airports it is hard to see what advantages privatization has. Commercial activities at BAA airports are contracted out to private operators in any event, and Government is heavily involved in important decisions regarding traffic activities through its environmental and civil aviation policies. However, it is in the water industry where the dangers of privatization appear greatest, because of a combination of concerns about the environment, natural monopoly, and infrastructure investment. While there is scope for contracting out some operations (e.g. sewage treatment and pipeline maintenance), in general there is little to gain from privatization in the water industry, and great problems lie in store if it goes ahead. We would retain public ownership of the industry's assets and would maintain the principle of integrated river-basin management.

The razzmatazz associated with stock market flotations is the most immediately visible aspect of privatization, but in the long run the British privatization program will be judged in terms of its effect on economic efficiency. By failing to introduce sufficiently effective frameworks of competition and regulation before privatizing such industries as telecommunications and gas, the Government has lost a major opportunity to tackle fundamental problems experienced in the past under public ownership. By pushing the program too far and too fast, the Government is undermining the long-run success of privatization in Britain.