EDITORIAL: LESSONS FROM PRIVATISATION

David Parker

Introduction

The 1970–74 Heath government and the Labour government of 1974–79 had both arranged some privatisations, the latter in the form of sales of shares in the petroleum company BP at a time of fiscal crisis. But a sustained programme of privatisation did not begin in Britain until the election of Margaret Thatcher as Prime Minister, in 1979. Although privatisation did not feature prominently as policy in the Conservative Party election manifesto of 1979, during the 1980s it grew to become one of the most important legacies of Mrs Thatcher's governments. In the 1990s both the John Major Conservative administration and the Labour government of Tony Blair, from 1997, continued to privatise, albeit at a slowing pace.

In her memoirs Mrs Thatcher reveals the importance she attached to her personal crusade against state ownership, writing:

> 'Privatisation . . . was fundamental to improving Britain's economic performance. But for me it was also far more than that: it was one of the central means of reversing the corrosive and corrupting effects of socialism . . . Just as nationalisation was at the heart of the collectivist programme by which Labour Governments sought to remodel British society, so privatisation is at the centre of any programme of reclaiming territory for freedom.'
>
> (Thatcher, 1993, p. 676)

The term 'privatisation' has been used variously to describe state asset sales, the contracting out of government services, public–private partnerships, and certain other reforms involving the reduction in direct state provision of goods and services. However, arguably it is very misleading to refer to changes, such as contracting out and public–private partnerships, as privatisation because the state remains primarily responsible for deciding the outputs and sometimes the inputs, instead of the market. Table 1 provides a summary listing of major privatisations during the 1980s and 1990s,[1] defined in terms of the transfer of state assets and their entire management to the private sector. Figure 1 provides a summary of the amounts raised through state asset sales in the same period. As the table and figure both confirm, Britain's privatisation experiment began cautiously, peaking in the early 1990s with the sale of the water and electricity industries. Unlike in a number of other countries, no 'privatisation plan' was published by government setting out a timetable for future privatisations. Rather, the policy evolved with each seemingly successful sale – defined in terms of the government's ability to sell the enterprise – triggering the planning of a further sale. Also, although government denied that the privatisations were determined by the need to raise revenues for government to support tax cuts and public expenditure, and in relation to tax and spending levels privatisation receipts were always small, it does not seem that generating government funds was an irrelevant consideration in the timing of privatisations. In addition to privatising industries, the Thatcher government also began an ambitious sale of the state's stock of housing ('council housing'), although other areas of the welfare state were little affected by privatisation. Privatisation of welfare services, especially health and education, were seen as a step too far politically.

Sell-offs took a number of forms including initial public offerings (IPOs) – mainly through offers for sale but some through sales by tender, trade sales (e.g. the sale of Rover cars, formerly British Leyland, to British Aerospace in 1988) and, on occasions, management and worker buy-outs (e.g. National Freight, some shipyards and a few coal mines). The early industry sell-offs involved businesses that were in competitive markets. Aerospace and shipbuilding, for example, faced intense international competition for orders; indeed, in the face of such competition the British shipbuilding industry was in terminal decline, something privatisation failed to reverse. The National Freight Corporation faced competition from numerous smaller domestic private companies and, while state owned, never held more than 10% of the market for freight and storage services in Britain. By contrast, a number of the major privatisations from the mid-1980s involved enterprises operating in monopoly markets, namely telecommunications, gas, water and sewerage, electricity and, later, rail transport. Previously they had been seen as 'natural monopolies' and therefore unsuitable for private ownership.

Official policy on the ownership of the public utilities began to change in 1983/84. Telecommunications experienced fast technological change that reduced its earlier natural monopoly characteristics, such as optical fibre cables, new switching gear and wireless-based technologies.

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At the same time, technological change necessitated large-scale investment to meet the expected demands for telecommunications services, especially data transmission and cellular phones, which the British government with its budgetary problems felt unable to meet. In 1984 50.2% of BT's shares were floated in the stock market; the remainder of the shares were sold in two further tranches, in December 1991 and July 1993. Also in 1984, a new fixed-line operator was licensed, Mercury Communications.

To protect the consumer from monopoly abuse new dedicated regulatory bodies were established, starting with the Office of Telecommunications (Oftel, now part of Ofcom) and moving on to Ofgas (for British Gas), Ofwat (for the water and sewerage industry), Offer (in electricity) and the ORR (for the railways) – later Ofgas and Offer were merged to form Ofgem – the Office of Gas and Electricity Markets. The establishment of this regulatory structure was piecemeal and ill-thought out and its ramifications are still with us in terms of controversy over the regulatory rules, structures and processes.

The flotation of state enterprises did help to expand share ownership in Britain. The percentage of adults holding shares rose during the 1980s, from around 7% to 25%. However, small investors continued to hold only a very small percentage of the total stock of each privatised enterprise, and the long-run trend towards increased institutional share ownership in Britain continued. The share of the stock market accounted for by private investors fell through the 1980s from 30% to 20%. Moreover, arguably, effective corporate governance is better achieved by creating blocks of large shareholdings – and therefore investors with a large individual stake in the future of the business – rather than small shareholdings. It was, therefore, by no means self-evident that promoting the small shareholder through privatisation was consistent with the objective of raising economic efficiency in the enterprises sold. As events unfolded, however, many small shareholders sold their holdings to make a quick, and effortless, capital gain. For example, of the 2.2 million initial shareholders in BT, some 500,000 left the share register within six months (Ernst & Young, 1994, p. 21).

In a number of privatisations a small percentage of shares were reserved for employees of the firm, as in the case of BT. This helped to diminish worker opposition to privatisation and weakened the ability of the trade unions to marshal direct action to prevent a sale. Unlike in France and Taiwan, for example, where privatisations met with strikes and demonstrations, it is one of the intriguing enigmas of UK privatisation that union opposition remained vocal rather than physical. Probably the simultaneous passage of anti-union laws by Mrs Thatcher's governments is part of the explanation.

Table 1: Britain's major privatisations

	Date of sale (where more than one date is given the shares were sold in tranches)
British Petroleum	October 1979 September 1983 November 1987
British Aerospace	February 1981 May 1985
Cable & Wireless	October 1981 December 1983 December 1985
Amersham International	February 1982
National Freight Corporation	February 1982
Britoil	November 1982 August 1985
Associated British Port Holdings	February 1983 April 1984
Enterprise Oil	July 1984
Jaguar	August 1984
British Telecommunications	December 1984 December 1991 July 1993
British Shipbuilders and Naval Dockyards	1985 onwards
British Gas	December 1986
British Airways	February 1987
Rolls-Royce	May 1987
BAA (British Airports Authority)	July 1987
British Steel	December 1988
Anglian Water	December 1989
Northumbrian Water	December 1989
North West Water	December 1989
Severn Trent	December 1989
Southern Water	December 1989
South West Water	December 1989
Thames Water	December 1989
Welsh Water	December 1989
Wessex Water	December 1989
Yorkshire Water	December 1989
Eastern Electricity	December 1990
East Midlands Electricity	December 1990
London Electricity	December 1990
Manweb	December 1990
Midlands Electricity	December 1990
Northern Electric	December 1990
NORWEB	December 1990
SEEBOARD	December 1990
Southern Electric	December 1990
South Wales Electricity	December 1990
South Western Electricity	December 1990
Yorkshire Electricity	December 1990
National Power	March 1991
PowerGen	March 1991
Scottish Hydro-Electric	June 1991
Scottish Power	June 1991
Trust Ports	1992–97 (various dates)
Northern Ireland Electricity	June 1993
British Coal	December 1994
Railtrack	May 1996
British Energy	July 1996
AEA Technology	September 1996
Train Operating Companies	Various dates in 1996/97
National Air Traffic Services	July 2001

Source: Parker (2004).

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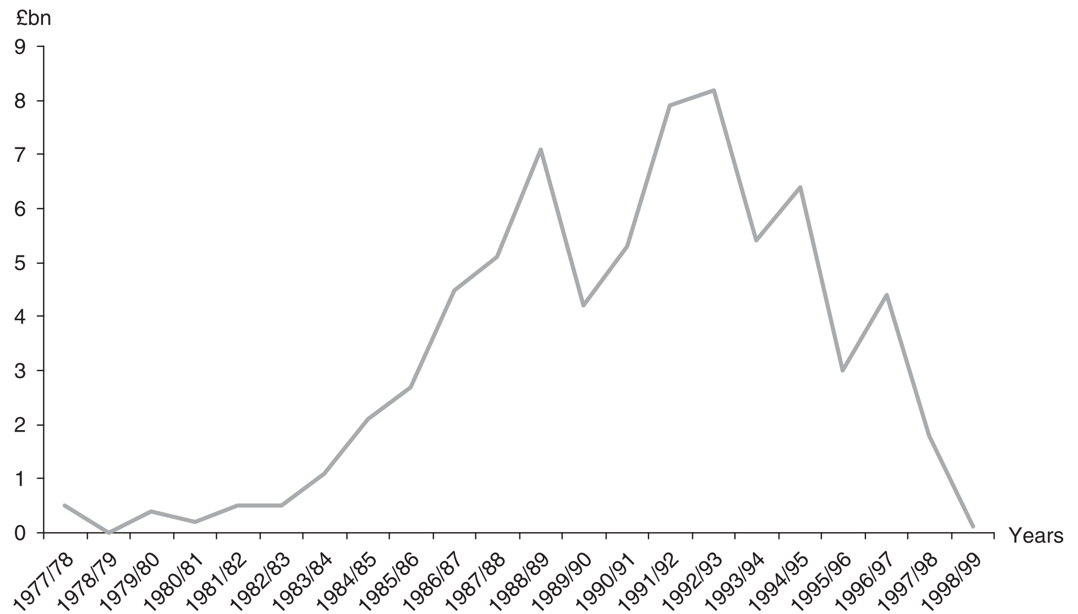

Figure 1: Privatisation proceeds, 1979–2000
Note: Figures exclude council housing receipts and receipts of subsidiaries retained by the parent. Since 2000 privatisation receipts have been minimal.
Source: HM Treasury, *The Financial Statement and Budget Report* (various).

Privatisation and economic performance

There were a number of privatisation objectives voiced by government ministers during the 1980s. Almost certainly macroeconomic pressures told in favour of selling government assets and the Conservatives had not forgotten the political pasting they had suffered in 1974 at the hands of the miners. Reducing trade union power was considered 'a good thing'. A shareholding democracy was also considered desirable as part of the process of promoting private property rights. But the overwhelming argument for privatisation lay in raising economic efficiency. State-owned firms were seen as sleepy and inefficient – over-manned and badly managed. The introduction of private capital offered the opportunity to raise productivity substantially. In this sense, privatisation policy was complementary to other 'supply-side' reforms from the early 1980s aimed at reversing Britain's relative economic decline, notably the reforms of market liberalisation, lower taxes and smaller government.

Principal–agent theory suggests that in privately-owned enterprises management faces superior incentives to drive out waste and maximise productivity (De Alessi, 1980; Bös, 1991; Boycko *et al.*, 1996). While public choice theory maintains that within government, as elsewhere in the economy, self-interest is the dominant motive, with the result that state ownership is associated with empire building, gold plating of public investments, over-manning and, in general, economic waste (Niskanen, 1973; Tullock, 1976; Mitchell, 1988). However, if ownership change is to have noticeably beneficial effects on economic performance, studies suggest that it needs to be combined with increased product market competition, and where state regulation continues, this may adversely distort efficiency incentives.

There have now been a large number of empirical studies of the effects of privatisation in Britain, and elsewhere (for a recent review see Megginson and Netter, 2001). Table 2 provides a summary of some of these studies (including some in which I have been directly involved). While some of these studies find statistically significant evidence of performance improvements following privatisation, other studies have reported mixed or even disappointing results, especially in industries where competition remains muted.

Nevertheless, it seems clear that in the public utilities, following privatisation, there have been large savings in labour costs alongside higher outputs, implying gross over-manning under state ownership, and lower prices to consumers. For example, in BT employment declined from around 238,000 at privatisation to 124,700 by 1999, and in British Gas employment declined from about 92,000 at privatisation to 70,000 by 1994. By contrast, in water services, where there is little effective competition, after privatisation employment rose at first, from 45,863 in 1990–91 to 58,270 by 1993–94. Only following a tightening of the regulatory price cap by Ofwat in 1995 did employment begin to fall.

In most of Britain's public utilities, again with the exception of water services, prices have declined in real terms since privatisation. For instance, in the electricity market the reduction in charges for domestic consumers in England and Wales between 1990 and 1999 was around 26% in real terms: the reduction for industrial and commercial consumers was even larger, totalling between 25% and 34%. It is important to recognise, however, that such figures are *average* savings and conceal disparities in the distribution of the welfare gains between different consumer groups (e.g. Hancock and Waddams Price, 1995; Waddams Price and Hancock, 1998; Markou and Waddams Price, 1999). In general, users with

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Table 2: Privatisation in Britain: a summary of performance studies

Author(s)	Industry(s)	Main performance measures used	Findings
Hutchinson (1991)	17 UK firms in several industrial groupings	Labour productivity, profitability and technology mix	Privately-owned firms outperformed comparable state-owned firms in the 1970s and 1980s in terms of profitability only. Less certain whether privatisation had improved performance.
Bishop and Thompson (1992)	9 privatised enterprises across a range of UK industries: including BT, British Gas and electricity supply	Labour productivity and total factor productivity (TFP), 1970–80 compared with 1980–90	There was higher growth in labour productivity in BT but the growth in TFP fell in the 1980s. In British Gas labour productivity grew at the same rate in the 1970s as the 1980s, while the growth of TFP declined. Electricity supply saw a fall in both labour productivity and TFP growth.
Haskel and Szymanski (1993)	12 privatised firms between 1972 and 1988, including BT, British Gas, electricity supply and water	Estimates of productivity growth (output per employee)	In the main productivity has grown faster in the 1980s. Competition is the significant causal factor.
Burns and Weyman-Jones (1994)	Electricity distribution	Multiple input, multiple output model of before and after privatisation using mathematical programming techniques	The 12 electricity distribution companies have been more efficient since privatisation, but this continues a long-term historical trend. There is also a greater diversity of performance amongst the 12 since privatisation.
Parker (1994)	British Telecom (BT) 1979/80 to 1993/94	Productivity and employment costs in total costs. R&D expenditures	Labour productivity has grown faster since privatisation, but the record for TFP is much less impressive. Employment costs have declined as a percentage of all costs, continuing a trend that dates back to before privatisation. R&D expenditures as a percentage of turnover have fallen, but this result is difficult to interpret because it may reflect a more efficient use of resources.
Bishop and Green (1995)	6 privatised enterprises including British Gas and BT	TFP and financial data, 1989–94	Competition rather than ownership is important. Growth in TFP in BT was in part due to technical change.
Waddams Price and Weyman-Jones (1996)	Gas industry, 1977/78 to 1991	Malmquist indices of productivity growth	Post-privatisation productivity growth was around 5–6% per annum compared with 3% a year before privatisation in 1986. However, differences remain in technical efficiency amongst British Gas's regions.
Newbery and Pollitt (1997)	Electricity generation	Various	Labour productivity has more than doubled since 1990, mainly due to shedding labour. Real unit costs have declined.
Shaoul (1997)	Water industry	Cost and output data	Greater efficiency gains, meaning lower costs relative to output, occurred prior to privatisation.
Saundry and Turnbull (1997)	Ports	Traffic and financial data including capital expenditure, mainly for the 1980s	The UK's privatised ports did not perform better than trust ports and municipally-owned docks. Service improvements have come mainly from employment de-regulation (the abolition of the so-called Dock Labour Scheme).
Martin and Parker (1997)	11 privatised organisations studied including British Gas and BT. Years before and after privatisation included	Labour productivity, TFP, various financial ratios and data envelopment analysis (DEA)	Mixed results with labour productivity growth evident but TFP growth lagging behind.
O'Mahoney (1998)	Sectors of UK economy including electricity, gas and water	Labour productivity and TFP in the UK relative to US, France, Germany and Japan	Productivity gap declined in 1995 compared with 1989; but evidence of a closing gap from the 1970s except relative to France.
Parker and Wu (1998)	UK steel industry compared with steel producers in six other countries	DEA analysis of relative input–output efficiency and productivity figures	A large improvement in relative performance occurred in the British steel industry before the privatisation. Privatisation was followed by a decline in relative performance.

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Table 2: Continued

Author(s)	Industry(s)	Main performance measures used	Findings
Parker (1999)	British Airports Authority – largest airport operator in the UK privatised in July 1987	DEA analysis of the relative performance of BAA pre- and post-privatisation and the relative performance of its individual airports compared with other airports in the UK privately and publicly owned	No evidence that privatisation had a significant effect on performance. Performance improvements were a continuation of a longer-term trend.
Harris *et al.* (1998); Cox *et al.* (1999)	Procurement practices in 28 privatised companies	Questionnaire and case studies	Evidence of improvements in procurement efficiency after privatisation, but some firms progressing faster than others and few close to achieving best practice.
Saal and Parker (2000, 2001)	Water and sewerage industry in England and Wales	Labour and total factor productivity and cost function	Privatisation led to no obvious rise in productivity or lowered costs of production. Higher productivity and lower unit costs came when the regulatory price caps were tightened in 1995.
Florio (2003)	BT's long-term performance over 40 years	Output, prices, revenues, costs, employment, productivity, profits and investment. The rate of growth of output was higher before privatisation. Prices fell with business users and international calls the biggest gainers	There was evidence of capital for labour substitution, while R&D expenditures fell as a percentage of turnover. Operating profits were stable before and after privatisation and privatisation had little discernible effect on productivity trends before 1991, when the introduction of more competition and new regulatory pressures led to large gains.

Source: Parker (2004).

lower marginal costs, usually larger users or industry, have tended to receive bigger reductions in charges than smaller, often poorer, consumers, who are more costly to serve (NAO, 2001).

Service quality changes since privatisation are particularly difficult to summarise because service quality is multi-dimensional. Nevertheless, there is no evidence that the lower manning and price reductions achieved in the public utilities have been at the expense of service quality. While, for privatised companies operating in more competitive environments, reducing service quality to the disadvantage of consumers is rarely a commercially sensible option.

Returns to investors following privatisation of the public utilities were high and, it seems, higher than government anticipated at the time of the sell-offs (otherwise presumably the government would have held out for a higher price for the shares at the time of their sale). The high profits and shareholder returns can be attributed either to the companies exploiting their market power in the face of limited competition, lax regulation or to government under-estimating the scope for cost savings following privatisation. Opinion seems to be divided on which of these explanations is the more important; probably all apply. What is clear is that the regulators have been able to respond to developments fully only when the price caps have come up for reconsideration, at so-called 'periodic price reviews'. (Although some regulators, notably the water regulator, intervened earlier and in the other industries companies were successfully cajoled from time to time not to increase their prices by the maximum permitted under their price cap.) Price cap reviews in the mid-to-late 1990s, in particular, reduced revenues to the privatised utilities, leading to significantly lower profitability and returns to investors closer to the cost of raising capital (or a 'normal' return). It is in no small part for this reason, for example, that the privatised electricity companies, which proved such a tempting target for takeovers by foreign companies, especially US-based utilities in the mid-1990s, have since been resold, sometimes at a loss.

Another obvious gainer from privatisation has been the senior management, many of whom kept their jobs at privatisation The introduction of stock options and profit-related bonuses led to large rises in the pay of senior management. This led, in turn, to media and union criticism of privatisation's 'fat cats'. At the same time, job losses, de-unionisation and changes to collective bargaining in a number of privatised enterprises (TUC, 1986; Ferner and Colling, 1991) produced a widening of pay differentials between unskilled workers and skilled workers and, of course, top management. One study suggests that privatisation did not lead to an obvious fall in *average* wages in privatised companies (Martin and Parker, 1996) but differentials have widened. There has been much variation in employment trends across privatised businesses and changes in pay and employment to a degree reflect wider changes in the British economy. It is worth noting that in some cases when large-scale redundancies occurred, e.g. BT in

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the early 1990s, many of those made redundant received generous redundancy packages. This means that in assessing the social welfare effect of privatisation, the effects on workers are particularly difficult to assess.

Lessons from Britain's privatisation experiment

The main lessons from Britain's privatisation experiment seem to be that, first, state-owned industries can be highly inefficient. Opening industries to market testing leads to incentives to bear down on costs and improve services. Second, privatisation can assist the extension of shareholding and provide valuable funds to 'cash-strapped' governments. However, privatisation is not a panacea. It works best when markets are not only privatised but opened up to competition. State regulation of monopolies is very much a second best and can reintroduce the sorts of inefficiencies that privatisation was intended to remove. Also, where privatisation policy pursues a mix of objectives – e.g. increasing shareholdings, raising maximum funds for government and efficiency gains – conflicts in policy occur. In particular, shares are attractive to investors and the sale price is maximised where firms continue to benefit from a monopoly. There can therefore be a conflict between a 'successful flotation' and longer-run efficiency incentives.

On balance, however, and in spite of some failures, privatisation in Britain has played a part, alongside tax cuts, deregulation and controls on public spending, in helping to create a more conducive environment for private investment. It should therefore be seen as part of a parcel of measures introduced in the 1980s to improve the supply side of the economy. Britain's experiment with privatisation came after decades of relative economic decline. The election of Mrs Thatcher occurred because of growing public discontent with poor economic growth, rising inflation, growing unemployment and poor labour relations. Privatisation has not proved to be an economic miracle, but arguably it has contributed to reversing the perception of Britain as 'the sick man of Europe'.

This issue of *Economic Affairs* includes five additional papers on British privatisation. The first, by Professor Ricketts, further considers the main lessons from the privatisations, including that 'privatisation *per se* does not automatically imply a reduction in the role of the state in economic life'. Professor Ricketts identifies a number of worrying developments in terms of the onward extension of the regulatory state in preference to the establishment of competitive markets, implying that privatisation is incomplete. Nigel Essex looks specifically at the privatisations of gas and electricity. He looks at the gains achieved since privatisation and some of the mistakes made, including, echoing Professor Ricketts, the failure to introduce sufficient competition at the time of privatisation into gas and electricity trading.

The next paper, by Professor Robinson, turns to a particularly controversial privatisation, the sale of the water and sewerage industry in England and Wales. Professor Robinson again identifies the absence of competition and intrusive regulation as important contributors to lacklustre performance. This study is followed by the paper by Dr Tyrrall, which tackles what many see as a 'privatisation failure', Britain's railways. Has the débâcle on the railways since 2000 been the consequence of unfortunate rail accidents and their aftermath, or is it attributable to the form privatisation took? From its inception until now, the privatisation of the railways has consistently been the most contentious of the UK privatisations. It has probably generated more media coverage than all the other privatisations put together. This may seem surprising given that virtually all of the population uses water, electricity and telecoms continually whilst only 8% of the population (mainly London commuters) use the railway on a regular basis. Dr Tyrrall identifies the causes of what he perceives to be 'a [slightly] qualified failure' in the complexity of the contracting system introduced into the railways at privatisation, with resulting risks and perverse incentives. Which raises the interesting question, would a different type of rail privatisation have been more successful? He argues that the railways had a structure imposed on them at privatisation that could only be operated with high transactions costs and which had not evolved in the marketplace.

Finally, Ian Senior considers a privatisation that did not occur, the Post Office. Interestingly, the Post Office remains one of the most strike-prone organisations in Britain. Ian Senior recommends the formal breakup of the Post Office into its main constituent businesses followed by privatisation and blames many of the recent problems in the Royal Mail on the organisation's struggle to retain its letter monopoly at all costs.

1. A fuller listing, including 119 organisations, can be found on the HM Treasury website: www.hm-treasury.gov.uk/documents/enterprise_and_productivity/public_enterprise

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