The Cost of Privatisation

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Conventional wisdom says the private sector is more efficient and public debt is always a risk. What if both assumptions were stifling good policymaking? Ian McAuley on the right way to fund infrastructure.

Which country has higher public debt — Spain or Germany?

The answer is Germany, with public debt at 80 per cent of GDP. Spain's is 70 per cent of GDP.

Germany can bear high public debt because its strong economic growth can service its debt. And more importantly, that debt has been used to finance productive assets — high speed rail systems, long-distance roads and metro rail systems.

Spain's problems relate not so much to public debt as to high private debt, which financed a housing boom, and it is becoming increasingly clear that much of that private debt will have to become public debt to keep the banking system afloat. While Germany's debt has financed up-to-date productive infrastructure, all that Spain has is a huge stock of unoccupied housing.

This comparison carries two simple messages. First, that there is nothing wrong with debt, provided it is used to fund productive assets, or, in accounting terms, so long as liabilities are matched by assets. Second, whether debt is private or public, it has to be repaid.

Here in Australia, we may look with envy at Germany's infrastructure. We have some glaring deficits — the public transport systems of Sydney, Melbourne, Brisbane and Adelaide, and our long-distance roads, such as the Bruce, Pacific and Duke's highways.

There is a strong case for using public debt to finance these infrastructure deficits. Our public debt, at all levels of government, is about 30 per cent of GDP, mostly in state governments. To put this figure into perspective, if we were to borrow another $300 billion for infrastructure, our public debt would be about 50 per cent of GDP, which is around the OECD average. And unlike the struggling European countries, we have plenty of leeway to raise taxes to repay debt, because we have some of the lowest taxes of all countries, as many economists and commentators, including Ben Eltham here at NM, point out. Better infrastructure contributes to economic growth and therefore our capacity to repay the debt — it's as simple as that.

Yet we are constrained by two obsessions. One, as mentioned above, is our public debt phobia, which has infected governments of all levels of both mainstream traditions. The other is an unquestioned assumption among policymakers that the private sector is intrinsically more efficient than the public sector. These obsessions reinforce each other, because we are too willing to use high-cost private debt when we would be better off using low cost public debt. Remember, whether the debt is private or public, we have to pay it off.

On Thursday last week the Productivity Commission released its draft report on electricity network regulation, which made news because it confirmed that network costs ("poles and wires") had accounted for more than half the rises in electricity prices over recent years (yet another voice contradicting Tony Abbott's rubbish about the impact of the carbon tax), and that we are paying dearly for the capacity to meet our peak demand spikes. Its other strong message was that remaining state-owned electricity assets should be privatised, as they have been in Victoria and South Australia.

The Commission rested its case on empirical evidence that state-owned transmission enterprises have higher operating costs, and it put these down to a host of factors which might be called poor management and poor governance. These included local procurement regulations, poor management of capital expenditure and cash flows (including dividend requirements), generous employee benefits and board appointments which are not necessarily based on merit.

I have no reason to gainsay the Commission's findings, and I know of some other case comparisons where similar results are found in private-public comparisons. (I can also cite cases where the opposite holds.) But does this establish an argument for privatisation?

A business principle, so basic that it shouldn't need stating, is that the first response to identified inefficiencies should be to reform. Imagine how shareholders in a listed company would feel if a company, having identified that it had mismanaged one of its divisions in a secure market, decided to sell it rather than to improve its performance, even though it would have to be sold at a discount. Yet that's what the Commission is essentially recommending.

The Commission acknowledges some costs with privatisation, including greater regulatory effort, and a higher cost of capital in the private sector, a point to which I will return. But in its suggestion that it can use regulatory mechanisms to provide incentives to require electricity network owners to cut costs, it is naively applying a simplistic economic model, overlooking the nature of business incentives.

The Commission points out that we do not need to expand our electricity distribution network: in fact excessive growth has been a reason for cost increases. Also, it's an industry with mature technology; hardly an exciting prospect for any gung-ho entrepreneur. Contrary to the simplified models in economic textbooks, firms seek growth — often at the expense of profit. Cost minimisation is not exciting, and encouraging customers to use less of your product just goes against the grain, even if there are financial incentives to do so. Such a set of requirements is surely more suited to the model of professional and conscientious public service management, rather than the growth-oriented private sector model.

In fact, the Commission did issue a fall-back recommendation, suggesting that if privatisation was to prove too difficult, presumably for political reasons, corporatisation, with enterprises kept in public ownership but at arm's length from government, would be a second-best option.

But there are stronger voices calling for privatisation. On the same day as the Productivity Commission reported, Infrastructure Australia released a report suggesting that $200 billion of infrastructure assets currently in public hands could be sold to the private sector, releasing funds for public investment in other assets. Its press release stated:

> "Infrastructure Australia called on governments to examine the sale of commercially viable, publicly owned assets to the private sector, in order to fund critical, new infrastructure."

Water and electricity supply between them constituted the bulk of IA's identified projects.

Unsurprisingly, the superannuation funds, including the industry funds in which unions have a strong interest, were enthused by IA's recommendations. Regulated monopolies providing essential services are rather nice cash cows, to use Boston Consulting Group's terminology.

Such enthusiasm should ring alarm bells, however. Australian governments have strong credit ratings, and can borrow at low cost. The Commonwealth Government ten year bond rate is less than four per cent. Commercial enterprises have a much higher cost of capital — they have to borrow at higher rates — at least two per cent higher — and even for secure industries such as utilities have to rely on a significant proportion of more expensive equity finance. Their cost of capital is around four per cent higher than the government's.

As a first approximation therefore, privatising all our electricity and water assets would cost about $8 billion a year (4 per cent of $200 billion), and all we would have to show for it is a lower government debt, offset by a higher private debt — which we would still have to repay.

This is not a blanket case for public ownership, but it does apply to utilities where there are mature technologies, standardised commodities, natural monopolies and the need to constrain consumption. There is also a case for public ownership of most transport networks which have some similar characteristics, as well as strong "public good" characteristics — in itself another topic. Nor is it a case for retention of all utility functions in the public sector — tasks like construction and maintenance can be contracted out provided competitive conditions exist. Rather, it is a case for the application of common-sense economics to our decisions about public ownership and debt.

Among politicians in the big parties, the only sensible voice in recent days has been that of Jeff Kennett, who pointed to the low cost of public debt to finance public infrastructure. Kennett has had the challenge of managing a state economy, and has first-hand awareness of the threat to the competitiveness of our cities posed by inadequate infrastructure. Also, with his days of seeking public office behind him, and with no personal incentive to make a stag profit from privatisation, he is free to articulate commonsense economics.