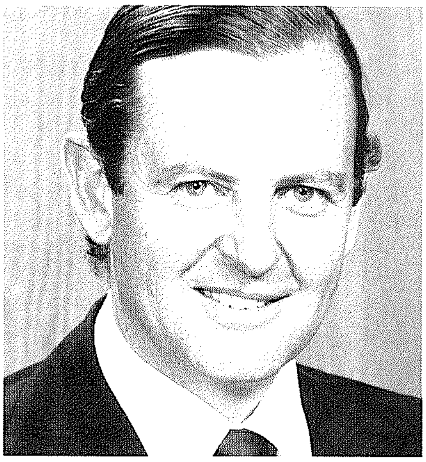
PUBLIC OR PRIVATE

MONOPOLIES AND THE QUIET LIFE



by H. M. MORGAN

The case for selling off the government monopolies — 'it costs the government about twice as much to provide a service as it would a private competitive producer.'

Australia has one of the largest public sectors in the Western world. The following industries are government monopolies: telecommunications, electricity supply, airports, railways (with the exception of the Pilbara), shipping terminals and ports, and water supply. The following industries are either so heavily regulated as to render them incapable of being competitive, enterprising or innovative, or else suffer from substantial government ownership, or both: education, domestic and international airlines, coastal shipping, and hospital and health services. It follows that a substantial proportion of the nation's capital stock is locked away from the critical appraisal of the capital markets.

Now that the federal government is actively considering privatisation as a method of overcoming the problems of debt and poor economic performance, Australia is in a position to make a quantum leap forward towards industrial and economic competitiveness. The securities industry has a pivotal role to play in this development.

The federal government, in its May statement, committed itself to realising approximately one billion dollars from the sale of government assets. The Williamstown naval dockyard is to be sold; Cockatoo Island, a substantial share in the Government Aircraft Factory, international aviation terminals, and part of the embassy site at Tokyo, likewise. The NSW government has similarly committed itself to selling the State dockyards at Newcastle. Prior to the May statement the idea of selling Australian Airlines, formerly TAA, was floated. The government backed off when a chorus of disapproval from the caucus resulted. It is difficult not to believe that the TAA sell-off proposal was a feint to occupy the caucus whilst the rest of the shopping list, or should I say selling list, was put together.

It is barely 18 months since the South Australian elections took place, when the Opposition not only lost the election but was covered in contumely for arguing that a number of State government operations should be turned over to the private sector. The public sector unions took out television advertisements against these proposals and it was argued by the Liberal Party Wets that it had been the privatisation proposals that were responsible for defeat.

The situation is now that fiscal stress will increasingly drive governments of any political flavour towards decisions that previously were regarded as unthinkable. My task today is to try to put forward an analytical foundation for what may well become a rush towards liquidation of government assets.

As in most discussions involving financial matters, we can begin by quoting Adam Smith. In Book II, chapter V of *The Wealth of Nations* we find the following:

The capital of all the individuals of a nation is increased in the same manner as that of a single individual, by their continually accumulating and adding to it whatever they save out of their revenue.

H. M. Morgan is managing director of Western Mining Corporation.

It is likely to increase the fastest, therefore, when it is employed in such a way that affords the greatest revenue to all the inhabitants of the country, as they will thus be enabled to make the greatest savings.

Australia has been dis-saving for some five years. We have been borrowing in order to live, and consume, in the style to which we have become accustomed. Not only must we give up this habit of consuming our capital stock; we must save more, and invest more, if our decline into banana-republic status is to be arrested and reversed. It is, however, one thing to save and invest. That is a necessary precondition for a return to prosperity and economic growth. But it is not a sufficient condition for prosperity and growth. For these things to occur, the investments that are made must be profitable.

It is the vital function of capital markets that they promote efficiency and profitability in the use of the capital stock of the nation, which is, as Adam Smith pointed out, the capital stock of the citizens. Capital markets, securities markets, stock markets, have long been regarded as the key institutions in our economic system. But they have been, and still are criticised as places where ruthless operators make ill-gotten gains at the expense of those honest people who actually work for a living.

It is not for me, when speaking to a meeting of the Securities Institute, to argue that people who work in these markets are more or less virtuous than those people who work, say, in the mining industry. What is important for the legitimacy of the securities markets is that their rules are known and observed, that entry into the market is open, and that the very great social benefits which flow from an open and honest market are widely understood.

These social benefits arise from the tradeability of capital assets in the securities markets. Companies which do not employ their assets productively and effectively find the stock value of their assets marked down by the market. Eventually they find themselves under new management. Not only is the reality of take-overs a boon to economic growth and prosperity. The prospect of take-over is at least as important a spur to productivity within a company as the threat of bankruptcy. Thus tradeability, and effective take-over mechanisms, are guarantors, at least in the medium to long-term, that the capital stock of the citizenry is being utilised in the most profitable way possible within the prevailing technological and legal framework.

	Capital Stock in Australia Billions of 1983-84 dollars		Mean Increase
	1971	1984	% (Compound)
Private sector			
Dwellings	75.3	129.9	4.3
Non-dwelling construction	54.4	87.4	3.7
Equipment	56.1	76.7	2.4
Public sector			
Public enterprises	66.7	106.6	3.7
General government	78.9	102.2	2.0
Total	331.4	502.8	3.3

Source: L.H. Cook & Associates

I have a table for distribution setting out the break-up of capital stock in Australia. From this table we deduce that as at 1984, the public sector controlled 42 per cent of the capital stock and that public sector enterprises, such as electricity, telecommunications, port facilities, railways, grain handling facilities, etc, make up 21.2 per cent. If we exclude private sector dwellings from our calculations, we find that governments control 56 per cent of our capital stock, and that public sector enterprises are responsible for 29 per cent.

It is this very large, non-traded and untradeable, proportion of the capital stock of the nation which should cause us very great concern. None of the assets employed in the electricity supply industry, telecommunications industry, postal services, airports, port facilities, railways, can be traded. None of these industries can be taken over except as the consequence of political processes. This sole possibility of take-over inevitably means that these industries become politicised, since advancement within the industry depends upon political preferment rather than commercial success. This gives us a theoretical understanding of why it is public sector industries, particularly those in monopolistic or subsidized situations, have used and will continue to use their capital stock ineffectively, and inefficiently.

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There are two fundamental elements in a growing and vital economy. The first is private property, and the existence of capital markets in which that property can be economically and securely traded. The second is freedom of entry into commercial and industrial activity. Freedom of entry means competition. All monopolies, because of the universal failings of human nature, are used to generate monopoly rents. The whole purpose of having a monopoly is to be able to enjoy those monopoly rents and the most enjoyable form of monopoly rent is a quiet life.

Australia's international competitiveness, the ability of the export industries to survive during a period of sustained low prices (with the notable exceptions of gold and wool), has been sapped for over half a century because so much of our infrastructure has become accustomed to enjoying monopoly rents and the quiet life that goes with them.

It is most important to understand that my arguments do not depend upon the notion that those people who work in the public sector are, by definition, spendthrifts, wastrels and lay-abouts and that, contrawise, those people who work in the private sector are hardworking, thrifty, diligent and consumed with the desire to serve the common good.

On the contrary, my arguments depend entirely on the hypothesis that all men and women are much the same, with the same mixture of benevolence and self-interest, regardless of where they find their life's work. Adam Smith summarised this view of human nature with his comment about the butcher:

It is not from the benevolence of the

butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interests. . . We are all naturally disposed to overrate the excellencies of our own character.

In the private corporation the management, at least, and often the rank-and-file (to use union terminology), have a great interest in the share price and the profitability of their company. This leads to very close attention to effective and efficient use of capital.

Management in a public sector monopoly is in a totally different position. There is no share price — there are no shares. The utility is described as a "national asset". Everybody owns it, so we are told.

W.S. Gilbert in *The Gondoliers* tells us:
When everybody's somebody
Then no one's anybody.

When everybody owns something, the reality is that no one owns it, and we have the economically debilitating situation where there are no residual claimants, to use the economic jargon, no caring shareholders, to monitor the performance of those who are in charge of the enterprise.

In the public utility there are no owners, no shares, and no profits. Some of you may object to this statement. Telecom, you will say, pays a return to Treasury based on capital invested. The SECV pays a return to the State government, likewise based on capital invested. My response is that these payments are not profits paid to shareholders, but monopoly rents paid to the Crown in return for monopoly privileges. The distinction is a vital one. Most of the arguments about cross subsidies, most of the industrial disputes within the public sector, are about the distribution and form of monopoly rents.

Our manager in the monopoly-positioned public enterprise then is in the invidious position where he cannot maximise profits; he cannot increase his share price. His primary concern must be the defence of the status quo. Since he cannot personally benefit from entrepreneurial activity (indeed, since the utility and his position in it may be threatened by the entrepreneurial activities of outsiders seeking to create rival services) he will, from natural considerations of self-interest, make it difficult and ultimately impossible for entrepreneurs to threaten the monopoly rents flowing to the public utility, and enjoyed principally by workers in that utility, and by the trade union officials who have monopoly rights of representation for that industry.

It is noteworthy that the managers of the public utilities are in the worst possible position. The trade unions have ensured that it is their members who collect the monopoly rents accruing to the industry and, further, the unions have obtained a veto over management initiatives and discretion. Top managerial salaries in the public utilities are significantly less than in the private sector. Thus we have a combination of frustration, poor rewards, and a total lack of opportunity to benefit personally from entrepreneurial endeavour.

The reason that our public utilities function as well as they do is that the important ones are run almost entirely by engineers, to whom professionalism is still an important principle in their working life.

But even engineers are not free from human foible and failure. Engineers have been known to indulge in gold-plating their equipment, to build facilities which are fascinating to operate, but which would not be built in a situation where profit maximisation was the primary objective.

The essential mechanism ensuring profitable and efficient use of capital is the existence of tradeable property rights — shares, for example — which put managers in the situation where profitability and efficiency are identified with their self-interest.

Let me quote again —
It is not from benevolence that we expect our dinner. . . but from regard to self interest.

So far I have been discussing these matters in the light of the theoretical understanding we now have of the operation of share markets, of the effect of take-overs and of the fear of take-overs. Is there any empirical evidence to back these theoretical arguments?

When Professor Gordon Tullock visited Australia in 1981 he made the comment:

The rough rule of thumb is that it costs the government about twice as much to provide a service as it would a private competitive producer.

I have since been on the look out for evidence, particularly Australian evidence, to test his observation.

In *The Australian* recently it was reported that the Department of Finance's preferred position is to abandon the National Museum. It also seeks to cut the National Film and Sound Archive, the National Gallery, the Maritime Museum and War Memorial. Now the inability of the government to manage its own affairs could not be more dramatically evidenced than by the scandalous building costs of the new Parliment House. The cost overruns on that project alone would have provided this nation all of the items the Department of Finance seeks to now abandon.

Mr Jack Johnson, formerly assistant general manager SECV, and responsible for the construction of the Newport power station, has recently presented a paper detailing the cost of delays to that project at $600 million in 1986 dollars. Without that delay there would be buckets left over after building a new library, new museum, and new Queen Victoria hospital, had that level of incompetence been avoided.

The road to impoverishment is very much in the hands of government.

In education, for example, we have worked out a figure of between $5,500 and $6,000 per year per secondary student in the government sector, and a corresponding figure of between $3,500 and $4,000 per year per secondary student in the non-government sector. That is a 36 per cent differential. I would be delighted if we could have an official response to these estimates.

In hospitals we have discovered that government hospitals cost $320 per bed per day to run, and non-government hospitals $150 to $160 per day. Here we find a 100 per cent differential.

Admittedly the government hospitals perform a teaching role, which must add to their costs, but it is difficult to imagine that it would explain away more than a small part of that differential.

In Melbourne we have private bus services operating on licensed routes, and we have bus services operated by the Met. Likewise in NSW, there are UTA (Urban Transport Authority) buses, and private buses. UTA buses cost about $3.20 per

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kilometre to run; private buses average $1.60. Once again we see the 100 per cent differential.

The standard textbook defence of public utilities has been the theory of natural monopoly.

Wherever a distribution network is required — electricity, telecommunications, gas, water, for example — it is argued that whoever owns the network has a natural monopoly and the monopoly rents thus created should go to the State rather than to private corporations.

What is curious about the history of these so called natural monopolies is that as soon as public utilities established their domain in particular industries they went to considerable trouble to convert their natural monopoly into a statutory monopoly. There has been a notable lack of confidence from the monopolists in the theory of natural monopoly.

Those public monopolies which own and operate networks — electricity supply, water supply, telecommunications, railways — argue that duplication of these networks is wasteful and unnecessary. Duplication may or may not be wasteful, but it is certainly not a pre-requisite for competition. By way of example, consider a suburb, serviced by an electricity distribution grid. It may be overhead or underground. For the purposes of our discussion that is immaterial. There is no intrinsic difficulty in 3 or 4 competing retailers of electricity, who independently buy from high-voltage, large-megawatt suppliers, and who sell it, in competition, to the residents of the suburb, be they domestic or commercial, but who at the same time have a contractual relationship with their competitors in the business, concerning the ownership, the maintenance, and extension of the distribution grid. We already have local electricity distribution and maintenance functions. The remaining 11 such profitable undertakings are reported to be under threat of take-over because of their very efficiency and profitability. There is nothing "natural" about the manner in which the SEC has progressively established its monopoly in this State.

Their interests as competitors are different. But their interests as joint owners of an electricity network are identical.

There are many network problems which lend themselves to this kind of solution.

The crucial element in any privatisation program is the creation of tradeable property rights. In every public sector industry that is costing Australia more than we can afford, we have to create concerned proprietors and caring shareholders.

It is of minor consequence which particular people are the lucky beneficiaries in the first allocation of property rights. Employees in the public utilities, beneficiaries of cross-subsidisation schemes, the Salvation Army or the Brotherhood of St Laurence, in my view, can all be seen as appropriate recipients of property rights when they are first defined. The crucial point is that these property rights must be tradeable, and that their value must not be enhanced by the simultaneous creation of monopoly rights connected with those property rights.

If this privatisation is done well, it will be of enormous benefit to Australia. The securities industry has a major role to play in seeing that we do do it well. I urge you all to play an active part. □

AGREEING TO DIFFER

Clash of the Titans is how the Melbourne Sun newspaper headlined a report of Mr Morgan's address, delivered in June to a luncheon of the Victorian division of the Securities Institute.

Mr Mel Ward, general manager of Telecom, challenged Mr Morgan to an impromptu debate following the Western Mining chief's denunciation of government-operated utilities. Mr Ward responded by saying Mr Morgan's speech was light on specific figures.

He also claimed that the privatisation of British Telecom led to much higher charges and poorer service.

According to The Sun, the debate was sparked when Mr Morgan accused some private sector groups of forming an alliance with Telecom to stop competitors entering the telecommunications field.

Mr Ward responded with a bevy of figures which showed that the now privatised British Telecom offered one of the most expensive phone services in the world.

By contrast, Australia provided a much cheaper service.

Mr Ward admitted Telecom had problems with work practices but said these were consistent with any large organisation.

In reply, Mr Morgan said the de-regulatory process had not finished in Britain and when the full competitive forces were unleashed there would be considerable customer benefits.

He said Telecom's work practices problems were caused by unions having monopoly rights.

Mr Morgan cited the case of one private exchange in Britain that was run more efficiently than the general network but he could not recall the name of it.

Mr Ward provided the answer — it was the Hull exchange and he was not impressed with the example.

"Hull is a blip in history. It is so small that it's like comparing BHP with a corner store."

Not to be deterred, Mr Morgan had the last word and said Mr Ward had not addressed the central issue of what future the various parts of Telecom should have.