Policy Backgrounder

NEW ZEALAND BusinessROUNDTABLE
PROMOTING POLICIES FOR A BETTER NEW ZEALAND

No. 5 DECEMBER 2004

# Does Privatisation Work?

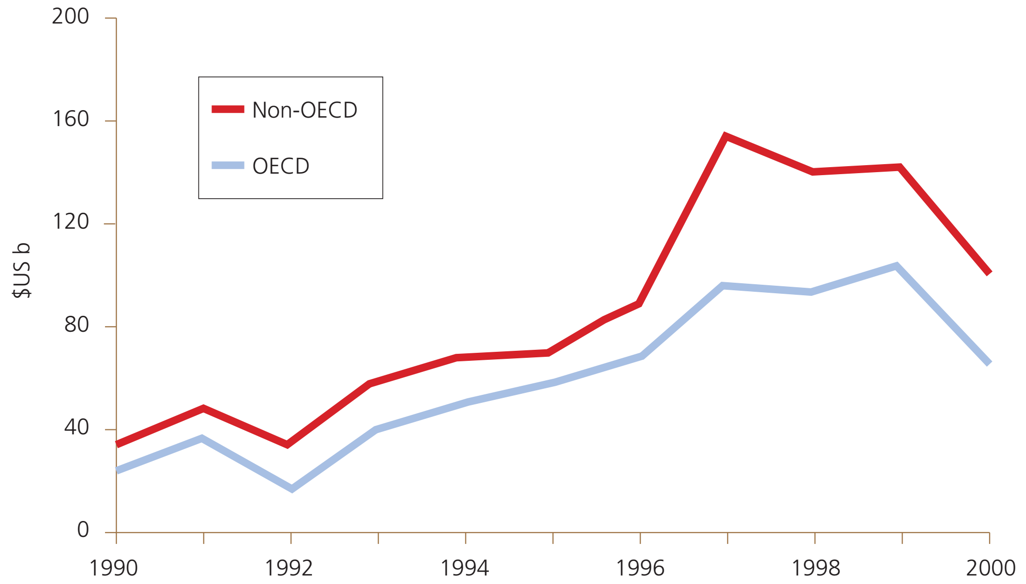
*Phil Barry*

Over the past two decades there has been a large, worldwide shift in the control of commercial enterprises. Since 1990, close to one trillion US dollars of assets has been transferred from public to private ownership[1]. The share of state-owned enterprises of global GDP has declined from around 12 percent in 1979 to less than 6 percent today.[2]

The World Bank has noted that "privatisation is now so widespread that it is hard to find countries not using the approach: North Korea, Cuba and perhaps Myanmar make up the shrunken universe of the resistant."[3]

***Privatisation is now so widespread that it is hard to find countries not using the approach.***

**Global Proceeds from Privatisation**




Centre-left governments (eg Britain, France, Germany and Norway and at the state level in Australia) have been among the most active in reducing the state's role in owning and operating commercial enterprises.

But just because everyone else is doing it doesn't necessarily make it right. The real question is does privatisation work?

1 Gibbon, H (2000), 'Editor's Letter', *Privatisation Yearbook*, Thomson Financial, London.

2 Megginson, W and Netter, J (2001), "From state to market: a survey of empirical studies on privatization", *Journal of Economic Literature* 34, p. 328.

3 http://rru.worldbank.org.resources.impact of privatisation

## Surveying the evidence

The empirical literature almost invariably shows that privatisation has increased business efficiency, enhanced the competitiveness of markets and increased overall economic welfare.

The table below summarises the results of a recent survey of published academic studies. Of the 22 studies surveyed, 20 found that businesses performed better after they had been privatised. Of the 10 studies that compared the performance of public and private enterprises operating in the same industry, eight concluded that private enterprises performed better.

*Privatisation has increased business efficiency, enhanced the competitiveness of markets and increased overall economic welfare.*

### Formal Studies of the Relative Performance of the Public and Private Sectors

| | Private Superior | No Clear Difference | Public Superior |
|---|---|---|---|
| Effects of Privatisation | 20 | 1 | 1 |
| Private vs Public Performance | 8 | 2 | 0 |

Source: Megginson and Netter, Journal of Economic Literature, 34, 2001.

In addition, privatisation was found to increase the competitiveness of the markets that former state-owned enterprises (SOEs) operate in. This is because previously state-subsidised or favoured firms had to succeed (or fail) on their own merits.

Three recent surveys by the Organisation for Economic Cooperation and Development (OECD)[4] and World Bank[5] have provided equally conclusive findings. In total the surveys reviewed over 50 published empirical studies examining hundreds of privatisations. Few issues in economics have been subject to such exhaustive empirical investigation and provided such clear results.

The balance of evidence conclusively indicates that:

- private firms tend to be more efficient than their state-owned counterparts, especially in competitive industries;
- privatisation of an SOE is likely to lead to improvements in the efficiency of the enterprise and to a more open and competitive market, to the benefit of consumers, taxpayers and the economy as a whole.

The evidence does not suggest that private ownership is *always* more efficient. Some state enterprises can perform very well, at least for a period. Conversely, as the case of Air New Zealand has highlighted, private companies can and do make mistakes. But the balance of evidence clearly demonstrates that, on average and over time, the private sector is likely to be more efficient than the public sector at running commercial enterprises.

4 Gonenc, M, Maher, M and Nicoletti, G (2000), 'The implementation and the effects of regulatory reform: past experience and current issues', OECD Economics Department Working Papers No. 251, Paris.

5 *Shirley, M and Walsh, P (2000) 'Public versus private ownership: the current state of the debate', World Bank Research Working Paper #2420, July 2000.*

## Hasn't it all been done in New Zealand?

But does this matter for New Zealand? Hasn't it all been done?

Not at all. As the adjacent table shows, the New Zealand government still owns a vast array of commercial businesses, with assets totalling $22 billion. Local government owns even more, with investments in airports, commercial property, forestry, ports, power companies and a variety of other assets.

The economic studies noted above don't just indicate that there are benefits from privatisation; they indicate that the gains from privatisation are large. The benefits come in the form of more efficient and profitable businesses; greater competition in markets and thus often better quality and lower cost goods and services for consumers; and greater and/or better targeted investment.

In the most comprehensive study undertaken by the World Bank, the net gains to the economy from privatisation averaged 26 percent of the firms' pre-divestiture sales.[6] A similar gain from privatising New Zealand's central-government-owned businesses alone would boost the country's GDP by around 1 percent per annum.

### Major Government Businesses, 2002

| Enterprise | Assets $m |
|---|---|
| Accident Compensation Corporation | 3,781 |
| Air NZ | 4,083 |
| Airways Corporation of NZ Ltd | 104 |
| Crown Research Institutes | 435 |
| Genesis Power Ltd | 1,105 |
| Housing NZ Ltd | 4,185 |
| Landcorp Farming Ltd | 561 |
| Meridian Energy Ltd | 2,669 |
| Mighty River Power Ltd | 1,614 |
| New Zealand Post Ltd | 630 |
| Solid Energy NZ Ltd | 131 |
| Television NZ Ltd | 520 |
| Transpower NZ Ltd | 2,280 |
| Total | 22,098 |

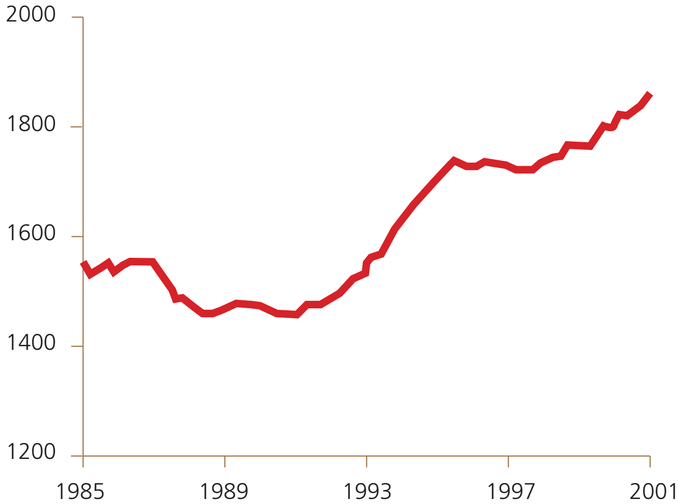
***The New Zealand government still owns a vast array of commercial businesses, with assets totalling $22 billion.***

## Addressing the criticism of privatisation

Many fears were raised about privatisation in New Zealand during the mid-1980s and 1990s. With the advantage of hindsight we can see that these fears had little substance:

- Privatisation didn't lead to fewer jobs. Overstaffed SOEs had to shed jobs but the economy as a whole gained. Total employment in the economy has grown by 22 percent since 1988.
- Privatisation has not increased the level of foreign control of New Zealand. Regardless of who owned the shares in the SOEs, the assets stayed in New Zealand, as did the jobs and the government's sovereign powers to tax and regulate.

**Employment '000**




6 *Galal, A, Reroy, L, P. Tandon, P and Vogelsang I (1994)*, Welfare Consequences of Selling Public Enterprises, *Oxford University Press, Oxford*.

There are in fact very good reasons for allowing foreigners to participate in asset sales. The number of bidders increases, thus increasing the likely sale price for the taxpayer. Foreign ownership facilitates the transfer of best practice international technology and know-how to the firm. New Zealand's small size and remoteness make it all the more important that our companies can access international capital markets.

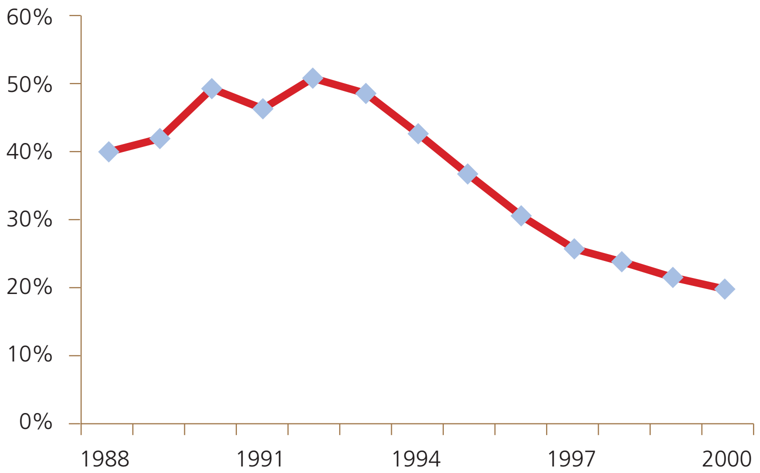
- The Crown's financial position was strengthened, not weakened, by the asset sales. New Zealand's public sector debt declined dramatically (from over 50 percent of GDP in 1992 to under 20 percent currently), with the proceeds from privatisation accounting for over half the decline.

It is sometimes claimed that despite the economic costs, public ownership helps the government achieve its social goals. But there are almost certainly better ways to do so, such as direct assistance to low income households.

A privileged few may benefit from state ownership. But the great majority of those on lower incomes are likely to be penalised through the lower quality, more expensive services that state enterprises typically provide and through the lower economic growth that results.

*A privileged few may benefit from state ownership. But the great majority of those on lower incomes are likely to be penalised.*

**Net Public Debt as a Percentage of GDP**




## Has privatisation worked in New Zealand?

The objective evidence indicates that New Zealand, like other countries, has benefited from privatisation. To take two major examples:

- The privatisation and deregulation of Telecom New Zealand brought large benefits (estimated at $0.5 billion per year) to consumers. These include significant declines in the price of phone services, reduced waiting times for services and increased access. There were benefits to the company from higher productivity and increased output.
- Despite concerns about the performance of Tranz Rail, the privatisation of New Zealand Rail has benefited the economy by up to $9.8 billion in total as freight prices have fallen and taxpayers have been relieved from continuing to subsidise the business.

Many other former state-owned companies have flourished under private ownership. Examples include the Auckland International Airport Ltd, BNZ, Capital Properties, Contact Energy, Postbank, Rural Bank, State Insurance, Wellington International Airport Ltd, Works Development Services and local government enterprises like the partially listed ports (Auckland, Lyttelton, Southland and Tauranga) and bus services (such as Stagecoach).

Not all privatised companies have succeeded. Air New Zealand failed spectacularly in 2002. But that doesn't mean privatisation has 'failed'. Sometimes private enterprises get it very wrong. That is the nature of private enterprise. But the evidence clearly shows that they tend to get it wrong less often than public enterprises.

That is not to say, by any means, that all activities should be privately owned. Governments have a key role to play in owning and providing such public goods and services as courts, defence, foreign diplomacy and police. Further, governments have a more general role of providing the legal and regulatory framework within which all enterprises operate.

## Which way for New Zealand?

In the last few years New Zealand, unlike the great majority of OECD countries, has seen the balance shift toward increasing public ownership of commercial operations. We have seen the energy industry steadily renationalised with state-owned entities buying retail customers from other energy companies (state-owned Genesis is now the country's biggest energy retailer), community trust-owned Vector's successful bid for United Networks (making Vector New Zealand's largest electricity lines company) and Solid Energy's buyout of Todd's share of Spring Creek (a joint coal mining venture on the West Coast).

In other sectors we have seen the renationalisation of accident insurance, the government's purchase of an 82 percent stake in Air New Zealand, the start-up of Kiwibank, the Auckland rail corridor buyback and then the acquisition of the whole rail track network from TranzRail, and the move to build up assets in the government's superannuation fund. At the same time, New Zealand (apparently alone among OECD countries) has had a comprehensive ban on privatising SOEs.

The expansion in size and scope of the SOEs reflects the inevitable tensions that arise when the state owns commercial enterprises. The businesses naturally want to expand and be successful. But we know from the evidence that public enterprises are typically not as efficient over time as private enterprises. As noted above, the differences are large enough to matter in terms of New Zealand's rate of economic growth.

**This article summarises a recent paper by Phil Barry titled '*The changing balance between the public and private sectors*', published by the New Zealand Business Roundtable. Phil Barry is a director of corporate finance advisory company Taylor Duignan Barry Ltd. He is a former Counsellor Economic at New Zealand's Delegation to the OECD.**