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Letter to the Editor

From Dr John Williamson

Michael Beesley and Stephen Littlechild argued for widespread and rapid privatization of the state sector in your issue of July 1983. Their argument is, however, unconvincing in two key respects.

In the first place, the paper offered no adequate support for the authors' key proposition that privatized concerns are more efficient and more responsive to consumer needs than are state enterprises. All that one can find in support of the efficiency proposition is a single footnote citing the work of one American economist relating to evidence from the United States. Whether this evidence, even granting that it can be accepted as definite for its home country, generalises to countries whose politics are less dominated by the pork barrel than those of the United States is surely a subject meriting research, not one justifying an *a priori* answer.

Beesley and Littlechild seem to believe that they are supporting the second part of their proposition when they tell us that 'Companies which succeed in discovering and meeting consumer needs make profits and grow; the less successful wither and die.' But in the fact the association between responsiveness to consumer needs on the one hand, and growth on the other, depends less on *ownership* than it does on the state of *competition*. In the case of natural monopoly, where productive efficiency demands a single supplier, whether companies prosper and grow or not depends overwhelmingly on how prosperous their market is and on how ruthlessly they exploit their market power. In the case of multiple producers, public enterprises are also more likely to prosper and expand when they are efficient and responsive to consumer needs. (Ask oneself why Singapore Airlines has grown larger than Ghana Airways — the answer does not lie in the question of ownership!)

The key issue, in other words, is not whether a concern is publicly or privately owned, but whether it is subject to the spur of competition. This throws a quite different light on the case for privatization. It means that there is no case at all for privatization of the natural monopolies in Beesley and Littlechild's Quadrants A and B. Even within their Quadrants C and D, where multiple suppliers are feasible, it

suggests that privatization should be judged on the basis of whether or not it can be an effective method of introducing or increasing competition. Privatization is irrelevant where competition is in any event going to be between a single British supplier and foreign competitors. Rolls-Royce provides the most obvious example; British Airways also comes close to this situation. If one wishes to increase competition in air transport, the obvious step is pan-European airline deregulation (allowing Air France to compete between Leeds and Belfast if it so pleases), not the denationalization of British Airways.

The second major failing of Beesley and Littlechild is one of oversight: they neglect the classic case where the ability to run at a loss provided by public ownership is a necessary condition for maximizing aggregate net benefits to consumers (which was of course, B and L's own criterion for judging the case for privatization). Elementary price theory teaches that marginal cost pricing is a necessary condition for maximizing consumer satisfaction, but that this will result in the industry running at a loss in a decreasing cost industry. Decreasing costs over the relevant range are empirically important in certain specific instances, notably railways and urban public transport. The objective presently set the railways, of maximizing revenue subject to obligations to provide specified services and a constraint to limit losses to a pre-specified level, gets closer to maximizing consumer satisfaction than an injunction to maximize profits would do, but it is still far from optimal. An objective specified in terms of equating price and marginal cost could almost certainly raise public use of the railways substantially without increasing the real resources absorbed by the industry, at the cost of a modest increase in the level of public subsidy provided. Yet this rationale for public ownership is completely neglected by Beesley and Littlechild.

If one goes along with their unproven axiom that private industry is necessarily more efficient than public industry, and one neglects the classic conditions under which the maximization of consumer satisfaction requires an industry to be run at a loss, then naturally one concludes that more privatization is necessarily better. But as economic analysis this is on a par with the old socialist prejudice that production for profit is the antithesis of production for use.

J Williamson,
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Washington DC.

Professors Beesley and Littlechild write:

The first part of Dr Williamson's comment misrepresents our argument in two respects: it focuses on only one of our arguments for private ownership, and it understates our own emphasis on competition. The second part of his comment, concerning the benefits of public ownership, is based on an idealized conception of a nationalized industry which is not supported by modern economic theory or borne out in practice.

We argued that "privatization will generate benefits for consumers because privately-owned companies have a greater incentive to produce goods and services in the quantity and variety which consumers prefer" (p.4). The "single footnote citing the work of one American economist" in support of this in fact refers to two survey articles covering over 200 different studies; about one third of these are empirical, and not all are from the USA. Recent research on British nationalized industries (e.g., by Richard Pryke) provides further supporting evidence. But this is only one benefit of privatization: we also pointed out that successful companies are able to grow; that the discipline of the capital market (with its threat of takeover) accentuates this process; that privatization substitutes market discipline for public influence (since nationalized industries are constrained by government's wishes reflecting political pressures); that private industries are freer to redeploy assets; and that privatization often provides political support for strengthening competition. Thus, increased efficiency and responsiveness is only one aspect, albeit an important one, of the case for privatization.

Dr Williamson favours competition rather than private ownerships. We can hardly be accused of neglecting this, since our section devoted to precisely this topic began with the words "Competition is the most important mechanism for maximizing consumer benefits, and for limiting monopoly power" (p.5). We were at some pains to point out that benefits from privatization would be reduced where monopoly power is unconstrained, and we argued that in such cases (quadrant A) it would be more fruitful to encourage competition than to privatize.

Dr Williamson goes too far in claiming that "there is no case at all" for privatization where supply prospects favour a single supplier (quadrants A and B). The exploitation of monopoly does not preclude the search for efficiency and new products. Rather, any losses due to greater exploitation of monopoly power have to be set against the gains due to privatization. Where demand is elastic and declining due to the emergence of preferred substitutes (quadrant B), the monopoly loss is likely to be minimal. Similarly, to claim that "privatization is irrelevant" where there is foreign

competition is to ignore the waste of resources if publicly-owned industries make losses due to inefficient operation. Finally, as noted above, competition and private ownership are not politically independent. To take Dr Williamson's own example, airline deregulation would certainly increase competition, probably more than would the denationalization of British Airways; nonetheless, denationalization would surely enhance the prospect of deregulation being adopted.

The second part of Professor Williamson's comment accuses us of over-looking the case where a loss-making public enterprise is necessary to maximize consumer benefits. The examples he gives of decreasing cost industries are singularly ill-chosen: urban transport is surely characterized by rising costs at the margin, and if marginal cost pricing were adopted in British Rail this would lead to higher rather than lower prices (because of present subsidy policy), hence to lower rather than higher public use. Moreover, his argument implies that effective competition in these industries is precluded by economies of scale (natural monopoly), whereas in fact it is precluded in buses by government regulationand in rail by the excess of present capacity. (The demand curve for rail services lies inside the potential entrant's average cost curve.)

The argument that public ownership plus marginal cost pricing will increase consumer benefits can no longer be taken seriously. In the first place, it is based on a static model of the economy which considers only the efficiency with which present resources are allocated, and ignores the dynamic problems of cost reduction and product innovation. All the available evidence suggests that these longer-term benefits far outweigh the short-term gains from improved allocation. In the second place, the assumption that governments and nationalized industries are seriously interested in setting prices equal to marginal costs is totally at variance both with modern economic theory of regulation (public choice) and with UK experience over the past 15 years. It would be more accurate to say that nationalization was designed precisely to *prevent* the allocation of resources from responding to market forces.

Let us summarize. First, privatization and competition are both means of benefiting consumers by increasing the role of market forces. But they are complements, not substitutes: each is necessary if the full benefits of the other are to be secured. Second, the alternative against which any such privatization policy is measured must be a nationalized industry as it is likely to operate in practice in the UK. To propose an omniscient public enterprise motivated purely by consumer interest is mere wishful thinking. We remain convinced that a policy of privatization, properly designed to promote rather than reduce competition, is likely to be beneficial in the great majority of nationalized industries.