Present at the SFB/ISPE
meeting on Public Production,
Bonn, August 1981.

Denationalisation: The Absence of Economic Analysis

S. C. Littlechild

*Revised version 4 September 1981

I

Readers of Arthur Conan Doyle will recall Sherlock Holmes drawing Watson's attention to the mysterious question of the dog barking in the night. "But the dog didn't bark in the night" says Watson, "Precisely", replies Holmes.

I have been invited to speak on "the new discussion on denationalisation of public production and its ideological, theoretical and empirical roots". After examining the literature, I have come to the view that my task is not so much to distinguish between the "new" and "old" discussions, as to explain why there has been virtually no discussion at all.

There is certainly discussion among politicians from time to time. The present Conservative government is committed to certain limited measures of denationalisation (as indeed the last Conservative government was). Here is an extract from the recent House of Commons debate upon the proposal to transfer gas appliances and showrooms to the private sector, a proposal which had been resisted by the chairman of the British Gas Corporation.

> "Mr. John Bruce-Gardyne (Knutsford, C) said he could not understand why the mandate of Sir Denis Rooke, chairman of the British Gas Corporation, had been renewed. His reputation as an entrenched and bigoted champion of monopoly privilege was unrivalled throughout the nationalised industries. It was time the Government took a much firmer line with him.
> Mr. Smith said it appalled him that an idiotic, ideological fop like Mr. Bruce-Gardyne had the temerity to attach such a distinguished and expert public servant as Sir Denis Rooke."
> (The Times Parliamentary Report for June 17, 1981)

* At the suggestion of the editor I have reduced to a single section the discussion of the 1978 White Paper (which originally constituted half the paper), and added a final section based on remarks made at the conference in response to the discussants' comments.

Are these the "ideological roots" referred to?

There is also discussion in the newspapers. On the very day I write this paper, one correspondent to The Times, dismayed by the pressure to dispose of the gas showrooms and the order to sell off the Gas Corporation's oil field, is led to conclude that a "more drastic remedy is needed"; he proposes that "they offer the whole British Gas Corporation, lock, stock and barrels of oil, as a going concern to the private sector ". (Letters, July 7, 1981). For some people, it appears, denationalisation is a last resort when all else has failed.

But what of economists? The entry on "Nationalisation" in the International Encyclopedia of the Social Sciences notes that the criteria for denationalisation have received "remarkably little attention" (Wiseman, 1968). Indeed, the most thoroughly argued case seems to have been presented, not by an economist, but by a politician (Powell, 1968). Friedman (1977, pp.51-3) has explored various devices for making outright denationalisation politically attractive, such as giving away shares to all the citizens of the country. Brittan and Riley (1978) have suggested giving away shares in North Sea Oil resour The present government's policies with respect to denationalisation, and some related analysis of my own (Littlechild, 1978 ch.VII, 1980), have been the subject of a pair of searching critiques (Heald 1980a, Heald and Steel 1980). Finally, I have made some practical proposals for change (Littlechild 1981). But this seems to be all.

This paucity of economic analysis is all the more embarrassing since everyone in Britain, without exception, is dissatisfied with the present institutional framework within which the nationalised industries operate, and denationalisation (or "privatisation") is frequently mentioned. Given the public esteem in which economists are held, it would be helpful if they could chip in with an occasional word of advice.

Why should it be that economists, who during the last 40 years must have covered acres of textbook and journal pages with discussion of the optimal pricing and investment policies for the nationalised industries, should have had nothing to say about the conditions under which denationalisation is an appropriate policy? It can hardly be because denationalisation is thought to be politically impossible, since the analysis of nationalisation itself is equally as conspicuous by its absence, despite the fact that the practise of nationalisation was frequently a full time activity during the period in question.

The answer, surely, must lie in the nature of the models which economists use to analyse the nationalised industries. To explore this possibility, it will be instructive to examine the response of welfare economists to the 1978 White Paper on the nationalised industries.

II

The original statues of nationalisation typically required the industries to act in "the public interest", to meet demand in an efficient way, and to break even financially. The 1961 White Paper introduced specific financial targets. The 1967 White Paper required investment projects to be appraised according to a common test discount rate (TDR), and prices were to be related to costs at the margin, subject to covering accounting costs in full. During the early 1970's, as part of its macroeconomic policy, the government repeatedly over-ruled these instructions with orders to freeze or increase prices, and halt or bring forward investment projects. A report by the National Economic Development Office (1976) found a lack of trust and mutual understanding between the government and the nationalised industries, confusion about respective roles, no systematic framework for making long-term decisions, and no effective system for monitoring performance. It held that the "arm's length" relationship was untenable in practice, and proposed instead a Policy Council for each industry, comprising representatives of all relevant interest groups.

In its White Paper of March 1978, the government argued that the situation had now improved, rejected the NEDO proposal for Policy Council,s and declared its intention "to reintroduce and reinforce the approach to investment appraisal, pricing policy and financial targets which was set out in the 1967 White Paper". However, the test discount rate was replaced by a required rate of return (RRR) on the investment programme as a whole, and the industries were given greater discretion in pricing to allow the particular circumstances of each industry to be taken into account.

Economists have differed in their reactions. Rees (1979a) concludes that the 1978 White Paper has been "largely successful" in restating the pricing and investment criteria "in a more coherent and intellectually respectable way". Webb (1979) believes that the practical difficulties of the 1967 guidelines were overstated, and is concerned about the greater emphasis on financial targets. Heald (1980) believes that the new proposals fail to resolve, and probably intensify, the dilemmas of the previous framework; that the 1978 Paper misleads when it claims to reinforce the 1967 approach; and that the return to a financial rather than economic approach is "a retrogression from its predecessor".

Yet there are important similarities in these evaluations. All three authors (i) limit their analysis to the financial and economic framework, ignoring the institutional proposals, and (ii) conduct their analysis in the spirit of neoclassical welfare economics, using the concept of efficient resource allocation as the criterion for appraising the proposed guidelines. Furthermore, they all accept (iii) that macroeconomic considerations and political pressures to redistribute income prevented implementation of the 1967 guidelines, and (iv) that the control framework, in both the 1967 and 1978 White Papers, is almost certainly inadequate. Yet despite the acknowledged importance of these last two considerations, they receive no more than a passing mention. Beyond brief reference to an efficiency audit, none of the authors gives any indication of how this severe deficiency in the 1978 White Paper is to be remedied.

In other words, the three economists whose views we have examined differed in their appraisal of the particular modifications in the 1978 White Paper, but they were in entire agreement that the task was to provide financial and economic guidelines which, if adhered to, would generate an efficient allocation of resources. At the same time, they felt that the 1978 guidelines were no more likely to be implemented than their predecessors, partly because of the lack of incentives and penalties bearing on the industries' management, and partly because of the conflicting pressures operating upon the government. However, no alternative proposals were put forward.

Not to put too fine a point on it, what we have discovered is that three economists have devoted a great deal of effort to analysing a financial and economic framework which they have every reason to believe will be largely ignored. They believe that the 1978 White Paper has little chance of success, but they are either unwilling or unable to propose an alternative framework more likely to succeed.**

III

It would be wrong to interpret this conclusion as a personal criticism of the three economists. They have all approached their task with skill, thoroughness and imagination. Their work is significant precisely because it represents the approach common to most economists of their generation: the approach of neoclassical welfare economics.

** It should be noted that Rees (1979b) and Heald and Steel (1981) have elsewhere analysed the problems of control in some detail, but I think it is still fair to say that their positive proposals for solving the problem are rather limited.

Under certain crucial assumptions (which are certainly open to challenge), neoclassical welfare economics is able to specify how pricing and investment policies should be tailored to particular conditions of cost and demand in order to achieve a specified objective. The National Board for Prices and Incomes expounded and applied these ideas rather well (Turvey 1971). But welfare economics is not able to specify how, in practice, the implementation of these optimal pricing and investment policies can be secured. It can give very little guidance as to which set of institutional arrangements is likely to prove the least defective.

This is not always, or even generally, the impression which undergraduate (and graduate?) students receive. They are shown, for example, how the adoption of marginal cost pricing can improve the allocation of resources in decreasing cost industries (under the assumptions of the model). They leap to the conclusion that nationalisation will achieve a more efficient allocation of resources wherever decreasing costs are found. (They also, in my experience, seem to believe that the acts of nationalisation which have taken place in Britain were, as a matter of historical fact, motivated precisely by the aim of improving efficiency in resource allocation.)

Such views are of course erroneous. Welfare economics is a body of normative theory which purports to tell us (inter alia) whether one pricing or investment policy is superior to another with respect to some specified criterion. It does not purport to tell us what policy actually will be adopted by a particular institution. That is, it does not claim to be a positive theory of how institutions actually operate. The very factors that cause differences in behaviour - notably the pursuit of self-interest under different sets of property rights and the costs of monitoring performance in the face of ignorance and uncertainty - these very factors are eliminated by assumption. In consequence, welfare economics is largely incapable of addressing the question of nationalisation itself. And this is surely why most economists have little or nothing to say about denationalisation.

IV

It is worth emphasising, perhaps, that the difficulties of analysing and comparing different institutional frameworks are imposed not by economic theory generally, but by the specific straightjacket of neoclassical welfare economics. This was not always the mode of analysis. Thus, a critic of the earliest proposals for marginal cost pricing wrote as follows.

> "Mr. Lerner is inclined to use the Rule as the principal criterion by which to decide whether or not an industry should be left in private hands. Since he proposes to apply the Rule quite generally, and since increasing returns are likely to be fairly widespread, he must be prepared for a large programme of socialisation far beyond the public utility field. It is surely strange that a conclusion derived from the marginal theory should in itself be regarded as a sufficient justification for a policy of this kind. The older economists would have spent much time discussing many other problems, such as the relative flexibility and inventiveness of public and private enterprises, and would have regarded the results of the marginal analysis as merely one of a number of considerations. Of course some economists would support socialisation in certain cases on other grounds; some would note. My object is not to take sides, but simply to mention the curious fact that many of the pros and cons which were once part of every economist's stock in trade tend to be almost forgotten in Mr. Lerner's statement of welfare theory." (Wilson 1945)

Examples can be give of analyses which take a broader view. Coase (1946) and Demsetz (1969) emphasised the need to consider the effects of any proposed pricing rule on overall performance. Foster (1971), more than any other economist, has embedded his analysis and suggestions in the actual working relationships between Parliament, Government and nationalised industries. Heath (1980) and Wiseman (1978) have explored some of the problems of management and control.

In the past, such approaches have been the exception. In the future

I suggest, they will be the rule. Three important developments in economic theory make this likely. First, the burgeoning literature associated with the phrases "public choice", "property rights" and "economic regulation" addresses itself precisely to such questions as how nationalised industries and sponsoring departments actually behave. Second, the reawakening of interest in the notion of competition as a rivalrous process, rather than as a state of equilibrium, provides the basis for a more realistic appreciation of how private (denationalised) markets function. Finally, the very recent literature on principal-agent problems of monitoring and incentives will surely prove most relevant in the analysis of franchises or subsidies which are likely to be involved in any programme of dentaionalising those industries where natural monopolies or unremunerative social services are required.

We may now return to the question posed in the second paragraph of this paper. It is certainly arguable that the "new discussion" of denationalisation differs from the "old discussion" insofar as it incorporates the new theories of public choice, market process and organisational behaviour. But while this statement would be true, it fails to convey the precise nature of the changes in economic thought that have taken place over the last half century. Would it not be more accurate to say that the "new discussion" is a welcome <u>resumption</u> of the "old discussion" after an interval of more than a generation, during which time economic theory developed along lines which precluded fruitful discussion of denationalisation?

V

The body of this paper is concerned to establish why there has been virtually no analysis by economists of denationalisation. The paper itself does not purport to provide the required analysis. Nevertheless, some comments on the form of such analysis might be appropriate.

First, there is a need for a coherent and comprehensive <u>positive</u> theory of nationalisation and denationalisation, in the spirit of Stigler's theory of economic regulation. This theory would attempt to explain why specific acts of nationalisation and denationalisation tookplace in the past, and perhaps could be used to predict future conditions under which previous policy would be continued or reversed. Some of the material for such a theory can be found in historical (and not so historical!*) accounts, but these will need to be reinterpreted, and new evidence sought, in the light of recent developments in economic theory associated with economic regulation and public choice. Whether a single underlying cause can be found is perhaps doubtful: Glaister's paper at this conference suggests half a dozen different motivating factors behind the increasing public ownership of London transport systems. Nevertheless, the important thing is to obtain a better understanding of why transfer from private to public ownership (and conversely) actually do take place.

Second, there is a need for a positive theory or account of how nationalised industries actually operate. This includes, of course, an account of how governments act towards nationalised industries. As I have argued elsewhere (Littlechild, 1979), the real problem of nationalisation is not so much to control the industries as to control the government. Coupled with this is the need for a better understanding of how private organisations operate in the market conditions under which nationalisation is usually adopted (e.g. local or natural monopoly).

* See footnote page 12

It will be crucial to establish, for example, how ownership is likely to affect pricing, production efficiency and innovation; the supply of capital; the nature and degree of intervention by the government; the practicability of implementing social (non-commercial) policies; the use and control of monopoly power, and so on. There is now considerable evidence on some of these matters from the USA, and evidence for British nationalised industries is beginning to emerge (e.g. the conference paper by Pryke and his two earlier books). It seems clear that the relevant economic concepts and techniques will involve much more than the extent of economies of scale or scope, or the extent of natural monopoly. As suggested earlier, the most important techniques will be drawn from the theories of public choice, competitive process and principal-agent relationships.

Third, a normative theory will have to take into account that denationalisation, like nationalisation, inevitably involves the creation, destruction and transfer of formal property rights and informal "entitlements". Just as nationalisation of shipbuilding involved the appropriation of some yards against the wishes of their owners, so too the denationalisation of (e.g.) coal would involve the depriving the miners of their "entitlement" to be paid according to the dictates of the political process rather than according to market criteria. A normative theory must therefore explain when and why such changes of property rights (and associated transfers of income) are desirable, and/or design schemes of denationalisation which involve adequate compensation.

Fourth, it is not clear how useful it will be to conduct the analysis of ownership and production in terms of general categories of goods and services. Professor Musgrave suggested as discussant that the judiciary is an example of a good that almost all would agree should be publicly provided. Yet there are numerous privately-operated systems for resolving disputes within the general framework of public law. For example, football (and baseball?) clubs have their own arbitration panels for assessing fair transfer fees, and the Automobile Association will arbitrate in disputes between its members and the companies with whom the AA has arranged insurance. One of the arguments for professional associations is that they perform a self-policing role. Examples could be multiplied. So the relevant question, it seems, is not whether the judiciary should be public or private, but which of the functions which might be served by a public judiciary could more appropriately be handled by private arrangements, and consequently over what domain the public law ought to extend.

Fifth, it seems clear that a study of denationalisation will have to examine each industry on a case-by-case basis, although with certain general principles in mind. Furthermore, it will not be helpful to consider denationalisation as an "all-or-none" solution. For many industries the relevant question will be: which parts of the industry ought to be denationalised? As a first step it seems sensible to denationalise where problems of monopoly and social (non-commercial) responsibilities are minimal, which will often result in part of the industry going private and part remaining public. My own suggestions for Britain are set out elsewhere (Littlechild 1981). Two examples will suffice here. (1) Electricity generation could be transferred to (competitive) private ownership while retaining public ownership of the national grid. (2) Terminal telephone equipment and international calls could be provided privately, and competing networks allowed to develop, while retaining public ownership of the existing national and local networks. Thus the problem is not really whether ownership of a whole industry ought to be transferred from the public to the private sector, but how the structure of the industry ought to be redesigned with a view to allowing maximal useful scope to private ownership.

One economist on whose work I have commented has written to me that, in analysing nationalised industries, he takes the fact of public ownership as given, since it would be an impossible task to appraise objectively the costs and benefits of nationalisation, and that changes in ownership are a matter for politicians rather than economists. I do not share this view. It seems to me that economists can and should attempt (i) to explain why nationalisation and denationalisation take place, (ii) to ascertain the likely advantages and disadvantages of each form of ownership, and (iii) to make suitably qualified recommendations for public policy. It also seems clear that normative theories of nationalisation and denationalisation will have to take much greater account of the way the world actually operates than conventional welfare economics has done in the past.

* (footnote page 9)

Sir Richard Marsh, former Chairman of British Rail, relates in his autobiography how he persuaded the Minister of Transport to keep rural railway lines from being closed by superimposing a political map of Conservative and Labour constituencies on the network of railway lines. He also says that Labour's plan for nationalizing Britain's ports was largely the result of pressure from the dock unions to bring efficient ports such as Felixstowe and Shoreham into public ownership. "The reason why the unions wanted those ports brought into the scheme was simply because their efficiency represented a threat to the less viable ports." (<u>Off the Rails</u>, by Richard Marsh, Weidenfeld & Nicholson.)

References

Brittan, S. and Riley, B., 'A People's Stake in North Sea Oil', Lloyds Bank Review, No.128, April 1978.

Coase, R.H., 'The Marginal Cost Controversy', Economica, Vol.13, August 1946, pp.169-82.

Demsetz, H., 'Information and Efficiency: Another Viewpoint', Journal of Law & Economics, Vol.XII, No.1, April, 1969, pp.1-22.

Foster, C.D., Politics, Finance and the Role of Economics, London, George Allen and Unwin (1971).

Friedman, M., From Galbraith to Economic Freedom, Institute of Economic Affairs, Occasional Paper 49, 1977.

Heald, D., 'Public Ownership and Denationalisation', Paper presented to the SSRC Seminar in Law and Economics, Hertford College, Oxford, 10-12 January, 1980a.

Heald, D., 'The Economic and Financial Control of UK Nationalised Industries', Economic Journal, Vol.90, No.358, June 1980b, pp.243-65.

Heald, D. and Steel, D., 'Some Implications of the Government's Denationalisation Measures', Paper presented to the inaugural meeting of the Royal Institute of Public Administration Workshop on Public Enterprise, Birkbeck College, London, 22 February, 1980.

Heath, J.B., 'Management in Nationalised Industries', NICG Occasional Papers, No.2, Second NICG Annual Lecture, 25 March, 1980, (Nationalised Industries Chairmen's Group).

Littlechild, S.C., The Fallacy of the Mixed Economy, Hobart Paper 80, Institute of Economic Affairs, London, 1978.

Littlechild S.C., 'Controlling the Nationalised Industries: Quis custodiet ipsos custodes?', Discussion Paper, Series B, No.56, University of Birmingham, Faculty of Commerce & Social Science, August 1979.

Littlechild, S.C., 'Towards Denationalisation', Journal of Economic Affairs, October 1981 (forthcoming).

National Economic Development Office (NEDO), A Study of UK Nationalised Industries, London, HMSO, 1976.

Powell, J. Enoch, Speeches at Watford, 12 September 1968, reprinted in his Still to Decide, Elliot Right Way Books, Kingswood, Surrey, UK, 1972, pp.106-114. (See also speeches to the Southport Conservative Women's Luncheon, Masonic Hall, Southport, 12 November 1970, and at the Corn Exchange, Loughborough, 15 May 1971, ibid. pp.114-20).

Rees, Ray, 'The Pricing Policy of the Nationalised Industries', The Three Banks Review, No.122, June 1979a, pp.3-31.

Rees, R. 'The Control of the Nationalised Industries', The Open University Press, 1979b.

Turvey, Ralph, Economic Analysis and Public Enterprises, George Allen and Unwin, 1971.

Webb, Michael G., 'A Critical Appraisal of UK Government Control of Nationalised Industries', Paper presented to International Symposium on Public Policy for Regulated Monopolies and Public Enterprises, Brussels, June 1979, and forthcoming in Proceedings.

Wilson, T., 'Price and Output Policy of State Enterprise: A Comment', Economic Journal, Vol.55, (1945), pp.454-61.

Wiseman, J., 'Nationalisation', International Encyclopedia of the Social Sciences, Vol.II, 1968, pp.70-5.

Wiseman, J., 'The Political Economy of Nationalised Industry', in J.M. Buchanan et al, The Economics of Politics, IEA Readings 18, London 1978.

Heald, D. and Steel, D., 'Nationalised Industries: the search for control', Public Money, June 1981, pp. 13-19.