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PRIVATIZING TRANSPORT INDUSTRIES

The British Experience

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1. INTRODUCTION

If any one policy has characterised the Conservative government in Britain since 1979 it is privatization. Although the policy was first canvassed in the United States, by the early 1990s Britain had become the world leader and privatization the country's most visible export (1). Moreover, transport industries were very much at the forefront of the Thatcher revolution in industrial ownership and organisation.

This paper firstly defines what is meant by privatization. Secondly, it assesses the economic reasons for privatization. Thirdly, it outlines the main privatizations that have occurred in the British transport market and assesses their impact. Fourthly, the applicability of the British experiment to other countries, particularly in the developing world, is considered. It is concluded that a necessary pre-requisite to privatization is commercialisation and as a result emphasis in many developing countries will be on reforming public enterprise rather than on out and out privatization.

2. WHAT IS PRIVATIZATION?

This is not as simple a question as first appears. The term privatisation has been used to describe a range of different policy initiatives designed to alter the balance between the public (ie. government owned) and private sectors. For example, Madsen Pirie, one of the high priests of the British privatization programme, has suggested 21 different methods that can be used to achieve privatization (2). These methods can be classified into three main groups (3).

The first, and most common usage of the term, is the change in the ownership of an enterprise (or a part of it) from the public to the private sector. Also referred to as denationalisation, this policy can proceed in a number of ways. A sale may be achieved through a share issue via the stock exchange, through a sale to private buyers or a sale to the workforce and/or management. At the extreme, denationalisation may involve giving the state-owned enterprise away or abandoning it through formal liquidation.

A second form of privatisation involves the liberalisation or deregulation of activities where the state-owned enterprise previously enjoyed protection. The state-owned enterprise remains in existence but faces increasing competition from private firms. As a result private firms gain market share at the expense of public firms. This form of privatization may be called competition-in-the-market.

A third form of privatisation is where the provision of a good is transferred from the public to the private sector, but Government specifies and, where necessary, pays for the good or service. Franchising (where firms pay Government to operate services), tendering (where firms are paid by Government to operate specified services) or contracting-out (the collective term for franchising and tendering) and the leasing of public assets to the private sector (where infrastructure is rented from Government by private firms) are example of this form of privatization. These forms of privatization may be called competition-for-the-market.

Privatization thus involves an increased role for private firms in industries that have been dominated by publicly owned firms. At its extreme, it involves the replacement of publicly owned firms by privately owned firms. Two points should be made here. Firstly, we define privately owned firms as those in which at least 50% of share capital is owned by individuals or non Government bodies. The numerous small railways in Switzerland are often referred to as private railways because they are not owned by the central government. However, in virtually all cases local Government is the majority (and usually the sole) shareholder and thus, by our definition, these railway companies are public not private firms. Secondly, we do not consider public enterprise reform, often referred to as commercialisation (setting the public enterprise commercial objectives) or corporatisation, (setting the public enterprise up as a public corporation with increased managerial freedom) as privatization, although it may be a prelude to privatization. For example, the so-called privatization of Japanese Railways, involving the re-organisation of the state enterprise into six passenger companies and one freight company, is not, as yet, privatization at all. Government remains the sole shareholder, although there are plans to raise private share capital for the three profitable passenger businesses on the Tokyo stock market.

3. WHY PRIVATIZE?

Privatization has a multiplicity of (on occasion conflicting) objectives (4) but three main objectives have emerged (5):

- improving economic efficiency and customer service
- reducing Government debt
- promoting wider share ownership.

Economists usually consider the promotion of economic efficiency and customer service as the main rationale for privatization and this paper will concentrate on this issue alone. However, it should be noted that politicians may often place more weight on the other objectives of reducing debt and increasing share ownership.

The main micro-economic case for privatization rests on the proposition that it may lead to a more efficient set of incentives for the firm (6). Incentives set by Government are replaced by those set by the capital markets and private shareholders. Managerial efficiency is increased by the constraints of bankruptcy and take-over that are not faced by publicly owned firms. The relationship between principals (shareholders) and agents (managers) is usually more clearly defined in private than in public firms. The scope for political interference is much less in a private than a public firm. This means that private firms tend to have less bureaucratic, less hierarchical (pyramid-shaped) organisational structures than public firms, and are more able to hire (and fire) labour as market conditions dictate.

What this suggests is that a private firm is likely to be more productively efficient than a public firm ie. it is likely to be able to produce a given level of output at a lower cost than a public firm. However, if the firm has some degree of market power it is possible that the publicly owned firm may be more allocatively efficient than the private firm in that it is more likely to set output and price at levels demanded by the market. If this is true, it is not clear what form of ownership is better for society as a whole.

However, ownership is only one of a variety of factors that influence economic performance. In particular, the degree of competition and the amount of regulation is also important. This has led to the emergence of two schools of thought in Britain: those who believe that privatization is a necessary step towards securing greater competition on the grounds that governments will not tolerate fair competition against their own enterprises (7); and those that counter that the obsession with privatization has meant sacrificing opportunities for introducing more competition (8).

Although there is plenty of empirical evidence on the comparative performance of public and private firms, much of it is flawed by the difficulties of comparing like with like and only limited data availability. Early studies suggested that even when comparing solely productive (or internal) efficiency there was little to choose between public and private firms (9) but subsequent studies have suggested that, where there is competition, private firms tend to be more internally efficient than public firms (10, 11) but again there may be exceptions. The evidence on allocative efficiency is also mixed. The consensus that seems to emerge is that the introduction of competition and organisational reforms have bigger impacts on efficiency than ownership per se. A good example is contracting-out, where Government draws up a legal contract with a private or public sector firm to provide a service. Real costs have been estimated to be on average lowered by 20% (12) due to the introduction of competition. Relatively efficient public enterprises can survive this process but the fact that many public firms are replaced by private firms suggests that some balance of advantage may lie with privately owned firms.

4. WHY PRIVATIZE TRANSPORT?

Some of the most radical reforms in the British privatization programme have occurred in the transport operations sector. Important sales have also occurred in transport manufacturing. Table 1 lists some of the main sales of transport operations. The reasons for this were manifold. Firstly, state activity in the transport industry in the UK was at a relatively high level in the early 1980s. Secondly, there were a number of profitable enterprises that could be easily transferred to the private sector. Thirdly, the transport sector was more competitive (or potentially competitive) than other sectors of the economy where the state had major interests (eg. electricity and water supply).

Table 1: Sales of Transport Operations
Derived from data presented in (13), except for BAA (6) and NBC (14).

Company	Date	Type of business	Gross proceeds
National Freight	Feb 1982	Road haulage	£5m
Associated British Ports	Feb 1983/ Apr 1984	Seaports	£97m
Sealink	Jul 1984	Ferries	£64m
British Airways	Feb 1987	Airline	£900m
BAA (British Airports Authority)	Jul 1987	Airline	£919m
National Bus Company (NBC)	Jul 1986 to Apr 1987	Local + express Buses	£300m

In political terms, the privatisations have been a success. The Government has raised revenue and increased share ownership with, in the transport sector, only token resistance from interest groups. In economic terms the results are more difficult to assess.

The sale of the road haulage firm, National Freight, has probably been the most unqualified success. There were large increases in productivity and profits and the firm has been a major innovator in the industry (developing 'bespoke' integrated distribution systems, that is systems developed specifically for individual customers, and 'just-in-time' delivery methods). The company was initially a management/employee buy-out but was in February 1989 very successfully launched on the stock market (15). However, a sceptical view of this privatization is that the Government did a poor deal for the tax payer by selling a property-rich company too cheaply to an 'inside' bidder (the existing management) at the wrong point in the economic cycle (i.e. during an economic recession).

British Airways has similarly performed well on the stock exchange and has improved productivity and profitability. However, these efficiency improvements occurred immediately prior to privatization and since privatization there have been concerns about the way British Airways has stifled competition through mergers (British Caledonian, Dan Air) and unfair business practices (Virgin Atlantic).

The bus industry is a particularly interesting case study in that it has exhibited all three forms of privatization mentioned earlier and is an area where Leeds University has undertaken extensive research (16, 17, 18). Express coaches were deregulated in 1980, as were local bus fares, whilst local bus services outside London were deregulated in 1986. Tendering or contracting-out for local bus services was introduced in London in 1985 and, for socially necessary services, in the rest of the country in 1986. Finally, the central Government owned National Bus Company was privatized between 1986 and 1988 as 70 separate subsidiaries. Its counterpart in Scotland, the Scottish Bus Group, was sold between 1990 and 1991 as 9 separate subsidiaries. Local government owned bus companies have been sold on a piecemeal basis, commencing with the local operator in Leeds, Yorkshire Rider, in October 1988.

The change in the structure of the bus industry has been drastic. In the country as a whole public companies' share of bus kilometres has declined from 92% in the mid 1980s to around 26% in the early 1990s. Of this 66% loss in market share, around 59% is due to ownership change, around 5% due to tendering and only 2% due to deregulation. One surprising feature of express and local bus deregulation is that existing publicly owned, or recently publicly owned, operators (incumbents) have by and large been able to see off entry by private firms.

The economic results of the reforms in the bus industry are the centre of rigorous debate and can not be all attributed to privatization. Outside London, operating costs have reduced by 36% between 1985/6 and 1991/2 and subsidy by 25%. There have been clear gains in internal efficiency, even if reduced wage rates are taken into account. However, there also seems to be allocative inefficiency in that limited competition has led to higher fares (up 13%) and higher frequencies (up 20%). On balance, it appears that society as a whole may be worse off (19), with demand for bus services decreasing by 22%. However, this disbenefit to society as a whole may be largely due to the reduction in subsidy rather than privatization (18).

In London, comprehensive tendering has been implemented on a rolling programme (route by route) basis. Around 40% of routes have been contracted out and private firms have gained a

40% share of these routes. Operating costs have reduced by 23%, whilst demand has remained steady. There have been gains in internal efficiency without losses in allocative efficiency; production costs have reduced whilst changes in services and fares have been in line with market demands. As a result, society is likely to be better off.

Why have these results occurred? The answer rests with the fact that the bus industry exhibits network economies. Incumbent operators have cost and revenue advantages from providing a network of services. For example, a bus company operating a network of routes may have lower costs per vehicle km than a company operating just one route because it is able to make better use of its vehicles and staff, whilst it may have higher revenue due to network ticketing and marketing. Competition-in-the-market will be distorted by the advantages large network operators possess, whilst at the same time diluting the benefits of network co-ordination and integration that are valued by passengers. Competition-for-the-market may reduce these incumbency advantages and maintain the benefits of co-ordination. The up-shot of this is that the London bus market (only around 16% private operators) may be operating rather more efficiently than the bus market outside London (over 80% private operators). However, the Government does not accept this view; privatization through ownership change and deregulation is planned for London in the near future.

The two transport sectors in Britain where the public sector remains dominant are the provision of roads and railways. In both areas the Government plans reforms. Tolled river crossings are common in Britain and some recent schemes have been developed by the private sector (the Dartford Bridge, the second Severn Bridge). Private tolled roads are common place in some continental European countries (France, Italy, Spain) and the Government wishes to see similar schemes in Britain (20), with the Birmingham Northern Relief Road likely to be the first scheme. The main concern is that private providers of road capacity may be only interested in situations where they have a monopoly. In such situations, there must be concerns that the private firm will abuse its market power through high prices and non-optimal investment (21). In such cases, regulation by Government would be required.

Increasing private sector involvement in the railways has been equally problematic and is another area where the University of Leeds has been active in research (22, 23). The main policy for the state-owned British Rail in the last 15 years has been one of public sector reform. British Rail has been set clearer commercial objectives and re-organised so as to be based on its main businesses (such as InterCity passenger travel, commuter travel, freight) in a process known as sectorisation. This lead to large improvements in performance; between 1979 and 1989/90 staff productivity (in terms of train miles) increased by 39% and the amount of subsidy required decreased by 43%. In financial terms, British Rail is probably the most efficient operator in western Europe (24).

The Government, whilst acknowledging the improvements British Rail has made, believes its performance has been held back by a public sector managerial culture. It believes that the only solution is privatization. Through the 1980s, British Rail's non-rail businesses in hotels, ferries, station catering and rolling stock manufacturing were sold to the private sector. Joint ventures with private sector freight companies were established but, given the depressed state of the economy, proved unsuccessful.

Privatization of the rail business is more complex because much of it is unprofitable and there are important inter-relationships between the businesses leading to joint revenues and costs. The

Government announced its intentions in a 1992 White Paper (25). As with the bus industry this has involved a mixture of approaches:

- the Freight and Parcels businesses and some stations will be sold to the private sector
- passenger operations will be split into over 20 businesses and franchised to the private sector. The first 7 businesses to be franchised have recently been announced. This process will be administered by a new Government body, the Franchising Authority
- the infrastructure will remain under Government ownership, under a new body called Railtrack. Rail operators will be given open access to the infrastructure
- another new Government body, the Rail Regulator, will be established to ensure fair play between the new private operators and the new Government bodies.

It is rather too early to assess these proposals but the main concerns that are emerging are: the potential inefficiencies of separating operations and infrastructure, the numerous new (Government) bodies required to administer the new system, the lack of compatibility between franchising and open access, the effect franchising may have on future investment and the effect competition may have on network benefits such as a national, co-ordinated timetable and integrated ticketing. It is likely that the privatization of the railways will meet more opposition than any of the other transport privatizations.

5. CONCLUSIONS

In many developing countries public sector eneterprises account for a large proportion of Gross Domestic Product and total investment, are perceived to be inefficient and have contributed to large budgetary deficits (3). It is tempting to recommend privatization as a solution to these problems and in the early 1980s agencies such as the World Bank and the International Monetary Fund were vigorously encouraging such remedies. However, the demonstration effect of the British experience should instil caution for two reasons.

Firstly, private capital markets in developing countries may not be able to sustain large scale prviatization programmes, particularly if foreign takeovers are prohibited. Moreover, even in countries such as Britain, with well-developed capital markets, it appears that public enterprises have been consistently undersold (6).

Secondly, the British privatization programme has not been an unqualified success in economic terms. Privatization has led to increases in internal efficiency but similar increases can be achieved through public sector reform (eg. British Rail, London Buses). Where firms have market power, the effects of privatization on allocative efficiency and hence the benefits to society are much less benign.

From our detailed analysis of the transport sector we offer the following conclusions:

(i) Public enterprise reform (commercialisation) is a necessary pre-cursor to privatization. There may be a progression from government department to government agency to public corporation prior to privatization. It is probably in this area that developing country effort will be concentrated in the 1990s.

(ii) Privatization is likely to be most successful in transport activities that are competitive and do not involve networks. Road haulage and paratransit (taxis and the like) may be such activities.

(iii) Many transport operations have some monopoly features due to their network characteristics. Privatization will require either regulation to ensure competition (eg. US airlines, the British bus industry outside London (26)) or Government control of the network and contracting out of operations (eg. rail, the bus industry in London). Monopoly problems become even more acute when attempting to privatize infrastructure (eg. roads, railways, airports).

(iv) Where privatization involves organisational reform, this will normally involve downsizing the public transport firm, ie. splitting it up into smaller units. In such cases attention will need to be paid to re-sales (Government should ensure claw-back arrangements are in place, so that Government gets back any profits that result from resales) and mergers (27).

(v) The transition from public to private ownership may result in significant transaction costs which could cancel out many of the benefits of privatization (28).

In conclusion, we would suggest that privatization, if defined solely as ownership change, is not the panacea to all economic problems, either in the developed or developing world. However, in conjunction with other policies, it can help improve economic performance in certain sectors. From the British experience, it seems that franchising/tendering should be considered for transport operations with network characteristics and leasing/concessions (concessions are where private sector firms buy the ownership rights to infrastructure for a certain period of time) should be considered for transport infrastructure. In such cases the State will still have an important role to play in specifying prices, service levels and infrastructure requirements. It is not too important whether there is a change in ownership; it is more important to have competition to operate transport services and infrastructure.

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