Partial sale :'worst of all options'

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There is something about telecommunications that seems to bring out the worst in policymakers.

The Government has already managed to dissipate most of the benefits of microeconomic reform in this area by encouraging duplication of the digital mobile networks and cable TV/telephony. Now the Opposition has announced its privatisation policy for Telstra and has managed to find the worst of all possible options.

Mr Howard's policy is to sell off one third of Telstra immediately. A Liberal Government will subsequently decide whether to sell off the remaining holding in its second term, should it be re-elected. The main motivation for the initial partial sale would appear to be the same as that of the various asset sales undertaken by the current Government; that is to make the Budget accounts look good.

As the Liberals have repeatedly pointed out with respect to Labor's asset sales, the apparent improvement in the Budget deficit is spurious. It simply reflects the fact that the Budget is a record of cash flows, bearing no relation to the level of public savings or the sustainability of fiscal policy. To the extent that privatisation is used to justify a larger Budget deficit (net of asset sales) than would otherwise be considered responsible, it is the fiscal equivalent of selling off the farm to pay the grocery bills. The parlous fiscal position of the United Kingdom illustrates the dangers of this course of action.

The situation is even worse when privatisation proceeds are specifically tied to the funding of expenditure programs in areas such as the environment (as proposed by Mr Howard) or roads (as proposed by Mr Costello). The fiscal effect is just the same as if these programs were funded by printing money. Moreover, the idea of tying expenditure programs to the passage of unrelated legislation on privatisation represents a major distortion of the democratic process and spending priorities.

Privatisation can only be assessed properly if the proceeds are used to repay debt. In this case, the critical comparison is between the flow of public debt interest saved and the (risk-adjusted) flow of profits foregone as a result of the sale. As Professor Bob Walker of the University of NSW and I have independently shown, this comparison will, other things being equal, yield the conclusion that privatisation makes the public worse off. The reason is that the rate of return demanded by private holders of equity is much greater than the rate of return on government debt. This 'equity premium' reflects the inability of private capital markets to spread all the risk associated with economic booms and slumps. The equity premium means that, other things being equal, the sale proceeds, when used to repay debt, will be too small to offset the loss of the profits of the enterprise.

To illustrate the point, consider Telstra's most recent annual profits of $1.7 billion, and assume that this profit is likely to be maintained in real terms; that is, at current inflation rates to rise by at least 3 per cent in nominal terms. Then the debt that can be serviced by such a profit is one for which the associated interest charge evaluated at a real interest rate of 5 per cent, is $1.7 billion. Simple arithmetic shows that this amounts to a value of $34 billion. Even the optimistic estimates on which Mr Howard has based his privatisation proposal suggest a sale price of around $24 billion, so that privatisation will make Australian taxpayers worse off by around $10 billion.

Other things are not always equal. If the new private owners of an enterprise can introduce substantial efficiency improvements, the increase in the flow of profits may offset the higher rate of return demanded by private equity holders. If this is so, the public will benefit from privatisation. But in the case of a partial sale, as proposed by Mr Howard, there is no change of management and hence no possibility of efficiency improvements beyond those that would have taken place anyway. The public suffers the loss associated with the equity premium but gets no efficiency benefit.

The best option, therefore, is either to retain the asset or sell it in one go. If it is believed that equity markets are too thin to absorb the asset in one go, the best way of selling is to commit in advance to a sale staged over several years. However, where equity markets are thin the equity premium is likely to be larger than usual, and the case for privatisation correspondingly weaker.

The position of minority shareholders in a publicly owned enterprise of the kind proposed by Mr Howard is such as to guarantee a low sale price. Should the Liberals lose the election after next, the shareholders would be at the mercy of the incoming Labor Government. If that Government should be genuinely hostile to privatisation, the minority shareholders would be unlikely to make large returns on their investment. Mr Howard is undoubtedly right in dismissing Mr Keating's protestations that he would never sell Telstra. But the next Labor Government will certainly not be led by Mr Keating, and possibly not by any of the leading figures in the present Cabinet. In these circumstances, it would be a foolish investor who offered the same price for a share in a partly privatised Telstra as they would offer in the case of a full privatisation.

The specific safeguards offered by Mr Howard make things even worse. The restrictions on foreign ownership will reduce the likely return, without offering any real benefit. If Telstra can safely be sold to private owners concerned only with profit, it makes little difference whether those owners hold Australian passports. In any case, previous attempts at safeguards of this kind have generally failed.

Finally, Mr Howard has apparently guaranteed the permanent maintenance of community service obligations (CSOs) and price caps. The ultimate effect must be a system of rate-of-return regulation of the kind long practised in the United States. In order to make the permanent preservation of CSOs and price caps feasible, it will be necessary to constrain Telstra's competitors and keep access prices high. The hoped-for competitive benefits of costly duplicate networks will have to be abandoned. If this is to be done, the Opposition should announce immediately that it will put an end to duplication, but there is no sign of this happening.

Properly implemented, policies of microeconomic reform have the potential to yield modest but significant improvements in national welfare. The Government's mishandling of reform in important areas such as the financial sector and telecommunications has so far negated any gains achieved in other areas, with the result that aggregate productivity growth has actually declined since the beginning of reform. It appears that a Liberal Government will do no better. ❑

Public comment on privatisation

Anne Davies (SMH 24/1/96):

'A government, as a shareholder, can decide to put policy ahead of profits. With a privatised Telstra, even a partially privatised one, making decisions which injure shareholder value of investors will be difficult.'

Max Walsh (SMH 24/1/96):

'As long as Telstra remains publicly owned there remains an inevitable conflict of interest on the part of the Government of the day as to the national telecommunications agenda. It is both owner and regulator.'

'Creating the economic environment so that Australia can maximise the returns from the telecommunications revolution has to be given absolute priority in terms of national policy. Privatisation - removing the Government's conflict of interest - is a necessary step in that process. It is one which governments around the world have come to reluctantly acknowledge.'

Tom Burton (AFR 24/1/96):

'Once there is one private shareholder on the registry, the Government no longer has control. ... Partial privatisations leave firms in the worst of all worlds. Neither private nor public.'

George Megalogenis (The Australian 25/1/96):

'Telstra is already run like a private business, with strict community service obligations imposed on it by government.

'It is not clear how a new Telstra, with two-thirds of its board appointed by a Coalition government, would be any more efficient than it is now.

'The risk is that Telstra's hybrid board may feel less obliged to pursue Howard's social agenda beyond the strict letter of his 'national interest safeguards' than would have been the case under full public ownership.'

Stewart Fist (The Australian 30/1/96):

'Where both Liberal and Labor economists fall down is that they view public-access networks as just another business. One side wants to reap the benefits of globalisation, and the other capital recovery by privatisation. Public networks are an essential component of the democratic process and the free market. They don't produce goods and services to be sold, but rather create the conditions under which goods and services can be freely sold.

'How can you use profits as the basis for private purchase when these profits are set by government-controlled price caps - and are set at a level guaranteeing the government top-up cash for its Budget?

'The problem in valuing a public-access network is that it is fundamentally an attempt to put a price on national commercial freedom'.

Mark Westfield (The Australian 5/2/96)

'Telstra in the eyes of politicians of both hues is simply a huge bag of money which can be cashed in gradually or quickly in two or three hits.'

Ross Gittins (SMH 5/2/96):

'Economists agree that the need to establish effective competition in a market is of far higher priority than the question of whether the firms in that market are publicly or privately owned.

'Privatisation has become the prime means by which governments cover up their fiscal irresponsibility.'

Ivor Ries (AFR 7/2/96):

'There are two main reasons why the Government won't be believed [that it won't sell any part of Telstra during the term of the next Government].

'First, Keating has broken almost every pledge he has made not to privatise nationally owned industries. One by one the ALP's sacred cows have been slaughtered.

'Second, everyone knows that, no matter which side wins office, the new Government will be confronted with a large starting-point Budget deficit, with estimates of the fiscal black hole running as high as $8 billion.

'Without raising taxes, or slashing government spending on big-ticket items like health, education and welfare, a Keating Government would *have* to sell part of Telstra some time during the next three-year term or be prepared to weather a massive Budget deficit blow-out....'