The basis of this assignment is to answer the question does privatisation necessarily increase efficiency? In answering this question it is essential to investigate the reasons for privatisation as a replacement for nationalisation. This assignment will compare the efficiency case for nationalisation with the efficiency case for privatisation in order to find out which theory is seen to be more efficient. By examining the privatisation of former nationalised industries such as the British railway system and highlighting the positive and negative changes that have taken place due to privatisation this will access whether privatisation has increased efficiency. To begin this assignment it is essential to highlight the history of privatisation in the UK.

Up to the Second World War, government enterprises were set up on an ad hoc basis were it was felt that state provision would be better than private provision in that particular case. The 1945 labour government led by Clement Attee, believed that nationalisation was a better option. His government nationalised coal, rail, steel, the Bank Of England and road transport. It created the gas boards and electricity boards that existed for the next forty years. The labour party after 1951 remained committed to further nationalisation but it was not a high priority. The two reaming firms that passed into public ownership were Rolls Royce in 1971 and Leyland cars in 1975 which both went bankrupt before public ownership.

In the late 40’s social, political and economic efficiency underpinned the nationalisation programme and in the same factors underpinned the privatisation programme 40 to 50 years later. Many of the same social and economic concerns existed to ensure that development was to exist through technological change and innovation. There was a lack of development before nationalisation in industries such as steel and also prior to privatisation in services such as BT. The lack of new investment and technology lead to allocative inefficiency.

High Quality and universality of service both geographically and by sector
Production is efficient in terms of minimising costs i.e. (X efficiency) whether through competitive forces and/or economies of scale. Equity in terms of the consumer’s ability to pay for monopoly services such as gas and electricity. When the price is inelastic the potential abuse of monopoly power has to be pre-empted by nationalisation or by regulation. Definition of Allocative Efficiency and X-Efficiency are taken from Public sector Economics by Stephen J Bailey

Alocative Efficiency. This is an aggressive economy-wide concept that requires inputs and outputs to be priced at their respective marginal costs and allocated in accordance with the preferences and income constraints of consumers. It is a question about what point on the production possibility frontier is optimal. Allocative efficiency occurs if the distribution of particular public sector outputs is not in accordance with those personal preferences, for example where a planner or monopolist distorts that allocation. In such a case it may be possible to redistribute resources making someone better off without making someone else worse off.

X-Efficiency. This is an organisation-specific concept denoting general managerial and technological efficiency at the same the level of the firm, bureau or organisation. It is a corollary of the profit maximisation assumptions that requires firms to use inputs, solve their organisational problems and produce output at least cost. However, X-efficiency may occur if organisations are insulated from competition by natural statuary monopolies. Being shielded from competition, bureaucrats may take ‘ on the job ‘ leisure, for example attending highly prestigious international conferences in attractive foreign cities and using unnecessarily generous expense allowance. In such cases they express preferences for cost items besides output, causing X-Inefficiency (also known as organisational slack).

The change in ownership of a monopoly places direct government ownership and control of the service, in which the pursuit for efficiency changes but the same objective still exists.

The efficiency case for nationalisation is related to the achievement of allocative efficiency and X efficiency. One of the main reasons for nationalisation is the prevention of monopoly power. The water and gas companies could possibly exploit their local or regional monopolies. Stephen Bailey argues "However it could be argued that the nationalised electricity and gas industries earned monopoly profits immediately prior to privatisation when, at the then conservative governments behest, they raised prices much more than inflation[1]".

Monopolies in the public sector may still abuse their position even if they do not obtain abnormal profits. Nationalisation simply changes the form in which monopoly power is made. The transmission of electricity through a national grid achieves economies of scale by avoiding duplication. To achieve the economies of scale government investment was required and many of the nationalised companies experienced a delay in the investment plan. Economies of scale may be necessary but not an efficient method for cost reduction, such reduction requires competition which monopolies lack.

Some of the nationalised industries existed to promote national security, industries such as steel and shipbuilding. Industries such as radioactive pollution from nuclear energy were nationalised in order to avoid substantial negative externalities. Special interest groups were selected for nationalisation, groups such as steel workers and railway workers. Rent seeking activities of public choice theory may have also motivated nationalisation. Stephen J Bailey takes definition of Rent Seeking from Public sector Economics

Rent Seeking is the adoption of behaviour patterns that achieve the maximisation of individual welfare or utility through calculation and equalisation of marginal rates of benefit and cost.

Privatisation in the UK began in 1970 with policy analysis by the Conservative opposition. Reducing the power of the public sector trade unions was an important objective. But in the early years of the conservative's government following 1979 election, privatisation was a marginal policy. Some public assets were sold-such as cable and wireless in October 1981 and Amersham International in 1982. Within ten years many public sector companies had been sold off to the private sector. Table 1.1 Highlights Nationalisation and privatisation in the UK

Table 1.1 Nationalisation and privatisation in the UK

[1]Stephen Bailey public sector economics 2002 page 342

Nationalised industries privatised between 1979 and 1999`	table 1.1
British Aerospace	British Shipbuilders
British Airport Authority	British Steel
British Airways	British Telecom
British Coal	Electricity generation and distribution
British Gas	National Bus Company
British National Oil Corporation	National Freight Consortium
British Railways	Water and sewerage (England and Wales)
Nationalised industries remaining within the public sector 2000	
British waterways board	London Transport
Caledonian MacBrayne	Post Office
Civil Aviation Authority	Water and sewerage (Scotland)
Other Privatised companies/enterprises/assets	
Amersham International	Jaguar
Associated British Ports Holdings	Rolls Royce
British Gas Onshore Oil (Wytch farm)	Rover Group
British Petroleum	Royal Ordinance Factories
British Rail Hotels	Sealink
Britoil	Short Brothers
Cable And Wireless	Trustee Savings Bank
Enterprise Oil	Unipart
Girobank	British technology Group and others
Her Majestys stationary Office	Local government seaports, airports
International Aeradio	Local government housing

Privatisation expanded the market sector transferring almost 50 major businesses to the private sector where efficiency has been improved by market disciplines. The sale of formerly state owned companies such as water and telephone transforms a public monopoly to a private a monopoly, in which government intervention is needed for the purpose of allocative efficiency and x-efficiency.

During the five decades between nationalisation and privatisation the political, social, industrial and economic conditions were not directly comparable between the time of nationalisation and privatisation. The main changes include the following forms of restructuring. First, economic and individual restructuring led to substantial technological change in the energy sector, oil and domestic heating. A Relative and Absolute shift of industry existed with employment moving away from the centre towards the suburbs and mass production gave way to small batch production.

Second, social and political restructuring The paternalistic, monolithic, standardised, collective form gave way to more emphasis on a pluralistic and enabling the state with individual self sufficiency, independence and personal achievement There was a fall in employment in the secondary and primary sectors whilst the services grew and a fall existed in the unionisation of workers and the political influence of trade unions.

The earlier achievements of the nationalised industries were not sustained in the long term and it’s failing led to the rationale for privatisation. The lack of competition stifled innovation and ongoing development of industries due to the monopoly position of many of the nationalised industries, resulting in poor quality services and lack of service. Stephen Bailey states ”The lack of profits incentives for the nationalised industries resulted in excessive costs[2]” The economic rationale for nationalisation was to improve efficiency as does the economic rationale for privatisation.

Under nationalisation the Stephen Bailey point out that “control of public expenditure, public sector borrowing and taxation was compromised[3]”. The Conservative government were committed to reducing public expenditure, which led to subside for loss making nationalised industries. An emphasis was inserted on supply side measures; the nationalised industries that were efficient were crucial for the efficiency of the whole economy. Due to financial cutbacks the need for major investment was instrumental in the privatisation of British Telecom, water and rail.

The change in ownership of a monopoly places direct government ownership and control of the service, in which the pursuit for efficiency changes but the same objective still exists. The major objectives of privatisation which emerged during the debate in the United Kingdom include the following: to reduce government involvement in the decision-making of industry; to permit industry to raise funds from the capital market on commercial terms and without government guarantee; to raise revenue and reduce the public sector borrowing requirement; to promote wide share ownership; to create an enterprise culture; to encourage workers to share ownership in their companies; to increase competition and efficiency.

During the early days of the debate in the United Kingdom the objectives of privatisation appear to be purely financial and managerial. It seems that the original impetus for privatisation came from a desire to discipline the nationalised industries by subjecting them to market forces. This in turn derived from the realisation that the administrative methods of controlling and monitoring the performance of the nationalised industries had largely failed and in its existing institutional form would from these relatively esoteric beginnings; privatisation began to acquire a set of more specific and often conflicting objectives. In this regard some commentators have pointed out that a less tangible yet nonetheless politically important objective, which drove the privatisation process, was the desire of the government to create a more entrepreneurial society.

With the sale of British Telkom, the out ration-alisation, for privatisation emerged. Regulation of private monopoly was seen as a more effective and efficient form of production than nationalised public monopolies. Private monopoly produces goods and services more cheaply, and any abuse of monopoly power can be controlled by the setting up of a new framework of regulation administered by a new regulatory agency and competition law. Thus, for the public utility industries, privatisation means a change from public production to what is regarded by the government as more efficient, private but regulated production.

It is said that customers will benefit from the prospect of higher standards, greater efficiency in the provision of services, a charging policy designed to pass on efficiency savings and keep bills down, and the opportunity to hold shares.

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[2] Stephen Bailey Public sector economics 2002, page 344

[3] Stephen Bailey Public sector economics 2002, page 344

Employees, because they are given an opportunity to buy shares in their own companies at preferential terms, will identify with their businesses and have greater job satisfaction and better motivation; so industrial relations will improve. The philosophical justification for the restructuring of state assets also provides an indication as to the methods of achieving it. Should it be an outright sale, or should it be an offer of shares by the privatised entity so that the money comes into that entity?

If the raising of money is the objective of privatisation then the former method will be selected' whereas if some of the other objectives referred to above are important then the latter method will be selected. Furthermore, outsourcing and sub-contracting of state activities also flows from some of the objectives referred to. As appears from the comments set out above, once a public entity is privatised it is essential that it be subject to a regulator and the normal competition laws of the land. Critics of privatisation have argued that the nationalised industries were efficient in the various terms; in practise it is very difficult to determine which is the most efficient form nationalisation or privatisation.

In principle it is possible to access the relative efficiency private of the industries by comparing their returns on capital employment with those achieved by nationalised industries. There are, however, a number of methodological difficulties in making such comparisons .The natural or statuary positions of many of the nationalised industries served to reduce the economic risks faced by them. In many cases their markets were virtually guaranteed: for example the former central Electricity Generating Board was virtually the only seller of electricity and the British Gas Corporation had a statuary monopoly for domestic mains gas supplies. Such was required within the return on capital employed for nationalised industries than for private sector companies.

The economic theory of a firm assumes profit maximisation. Hence the return on capital employed would necessarily be less for nationalised industries than for private monopolies companies. In practise even private sector firms may not maximise profits. There was a lack of comparable private sector companies since many of the nationalised services were primary sectors rather than secondary. Stephen Bailey states" In the practise there were no private monopoly companies that could legitimately have been compared with British Coal, the central Electricity Generating Board, British Rail and so on. Comparing them individually or jointly with the average rate of return on capital employment achieved by private sector manufacturing is methodologically suspect since many of the nationalised industries were in the primary (i.e. extractive) and tertiary (i.e. service) sectors rather than in the secondary (i.e. manufacturing sector[4]"

There was a lack of standardised accounting methods. It would incorrect to compare profit levels of public and private companies.Stephen Bailey states" Valid comparison of returns on capital employment requires standardisation in the measurement and valuation of capital and revenues. It would be methodologically invalid simply to compare profit levels as reported in the annual reports of public and private companies[5] "

[4] Stephen Bailey Public sector economics 2002, page 346
[5] Stephen Bailey Public sector economics 2002, page 346

The various accounting methods such as current and historic cost methodologies between the public and private sector to peruse a straightforward comparison of efficiency as measured by the return on capital employment.

The nationalised industries were used as macroeconomic instruments. Stephen Bailey points out" For example they were some times required by central government to accelerate or slow down their investment programmes as part of the management of aggregate demand. They were also sometimes required to restrict increases in their prices to below the levels required to cover rising costs, for example during periods of prices and incomes policy in early 1970s[6]". The nationalised industries also took social and economic functions. In principle it would be possible to compare like by like but in practise social functions are not separately costed so an accurate comparison cannot be made.

Since the methodological problems were difficult to compare the social and economic and political objectives serve to qualify the economic definition of efficiency. Perhaps the most important component of efficiency is the return on capital. Stephen Bailey states" The political economy context within which the nationalised industries operated meant that in, practise much broader concept of allocative efficiency overrode the narrower concept of X-efficiency. Social and allocative efficiency clearly encompass a much broader range of factors than simply the return on capital employment for a particular monopoly company. For example prices do rise due to (public) inefficiency, social gains to employees are of losses to customers[7]"

Despite such methodological problems the general picture was on of relative inefficiency. The inefficiency was not judged on historic situation, in terms of comparable private companies but in terms of potential improvements in efficiency when placed under a more competitive environment. The theory and evidence illustrates that competition has the greatest impact on economic performance. Transformation of monopolies from public to private does not change the competitive conditions therefore it is not validated by the theory of perfect competition.

Stephen Bailey believes argues that "Nevertheless the efficiency case for privatisation rests simply on the assertion that privatisation makes markets more competitive or contestable. In fact it is not evident that privatisation does stimulate competition. The degree of competition engaged by privatisation is crucially dependent on the form of privatisation and the market restructuring with which it is associated[8]". As already noted, the transfer of monopolies does nothing to stimulate competition since it has no effect on market structure. In cases such as the privatisation of BT and British Gas much criticism occurred because of their monopoly position. Stephen Bailey states " Competition may not be increased overnight, but over the long term industrial restructuring and technological change may make markets much more contestable and so create a spur towards increased efficiency[9]". British Telecom now face competition

[6] Stephen Bailey Public sector economics 2002, page 347
[7] Stephen Bailey Public sector economics 2002, page 348

[8] Stephen Bailey Public sector economics 2002, page 349
[9] Stephen Bailey Public sector economics 2002, page 349

from mobile phone companies and others such as NTL. The effect of privatisation depends on the method of privatisation. The common term of privatisation is the sale of state owned assets to private companies (table 1.1). The three main forms of privatisation are sale of state owned assets to the private sector, Liberalisation and encouraging private sector provision of public services.

The sale of state companies highlighted in table 1.1 can take four forms, which are highlighted by Stephen Bailey[10]:

- **Public flotation on the stock exchange**; share prices either being fixed in advance of sale (e.g. British Telecom and British Gas) or tenders being invited. In the later case, potential purchases offer to buy at prices specified by themselves (e.g. as for Britoil and Enterprise Oil)
- **A trade sale,** were the company is sold to a single firm or consortium (e.g. as for BR Hotels and Sealink)
- **Placing the company with a group of investors;** This approach was attempted for the electricity supply industry, but subsequently abandoned due to lack of interest.
- **A management or employee buyout,** (e.g. the National Freight Consortium). Some privatisations used a mix of approaches. For example a combination of offers and tenders was used for Cable and Wireless and Associated British Ports. British Rail was sold using trade sales for the rolling stock companies were sold by means of trade sales where capacity for trade purchase existed and where such a sale would not lead to a significant accumulation of market power. Former public utilities were sold through the offer of shares at fixed prices.

Liberalisation is when former monopolies are broken up to allow freedom of entry which should increase competition leading to an increase in efficiency. Stephen Bailey believes" Markets can be liberalised by dissolving former statuary monopolies so as to allow freedom of entry for competitors. Examples include deregulation of road and transport, less strict licensing for operators of long distance coaches and local bus services, and allowing other companies to start operations in telecommunications, electricity generation and in supply of gas to households[11]".

The company NTL is an example of liberalisation in the telecommunications sector; N-Power shows the liberalisation of electricity generation and Scottish Gas from the supply of gas to household. All the above companies are now seen as competitors to the former monopolies such as BT and British Gas, due to competition all companies have to become more efficient in there service to attract customers.

Encouraging private sector provision of public services can be separated into two different categories, franchising and contracting out. Franchising is selling the right to supply in a designated market usually to the highest bidder or who will provide an overall higher quality of service, the product must also generate revenue. An example of franchising is the provision of rail passenger services but on separately owned railway tracks. Contracting out to private companies that do not generate their own revenue such as waste disposal. The contract will go to the lowest bid, which can provide a quality service using the lowest possible payment. Both franchising and

[10] Stephen Bailey Public sector economics 2002, page 350-351
[11] Stephen Bailey Public sector economics 2002, page 351

contracting out maintain there monopoly status but the competition is not with other competing markets but by achieving cost reductions.

The three forms of privatisation can used independently or directly with each other. Stephen Bailey says "For example the sale of state owned assets is not necessary precondition for liberalisation and neither of theses is a prerequisite for contracting out. Some forms of privatisation involve neither the sale of public sector assets (i.e. liberalisation) nor the withdrawal of the public sector away from any of its activities (i.e. leasing and contracting out[12]"

The rationale and ultimate outcomes of the three forms of privatisation could be analysed by the term rent seeking. Baileys four forms highlighted above it have the potential to benefit particular groups or purchasers; these groups may apply political pressure in support for privatisation. It is agreed that liberalisation has the greatest influence in increasing competition and efficiency due to the increased numbers of actual or potential suppliers. The extent in which the other forms of privatisation increase efficiency and competition depends on the conditions of each sector.

The privatisation of some of the state owned services in particular British Petroleum failed to dramatically increase competition and efficiency because it already competed in a competitive market. With British rail hotels and ferry companies an increase in efficiency was expected due to the introduction of cost effective strategies. Stephen Bailey believes that "By allowing the public sector to produce a service if it submitted the lowest bid under CCT the then Conservative government accepted that it is competition rather than ownership that provides the spur to increased efficiency[13]". This tells us that the public sector is not necessarily less efficient than the private sector; using the example of British Rail we can see this theory.

Privatisation has fractured the rail network and handed it over to operators seeking to increase competition by cutting costs and manning levels. There have been nearly 100,000 redundancies since 1988. Today there is a very odd railway system in Britain. One company (Railtrack PLC) owns all the commercial railway track and stations, though it employs little staff and does not operate stations. Services (either Passenger, Mail or Freight) are provided by Train Operating Companies (TOC's) such as Scotrail who hires staff to drive and serve trains. Each TOC has to bid for a licence from the Rail Regulator, who hands out licences for Passenger, Mail or Freight services and ensures that the TOC's comply with the terms of their licences. British Rail's former rolling stock (locomotives, carriages and multiple units) is owned by Leasing Companies who lease the stock to the TOC's.

Since Privatisation there have been both advantages and disadvantages discovered. Train Operating Companies (TOC's) has invested in new stock, the Freight-Haulage scene on the railways has dramatically improved (from almost no freight on British Rail) and reliability of services has increased dramatically (because both Railtrack and the TOC's can be fined for causing a delay on the system for whatever reason). However, if the future started off bright, then the bulb needs changing. Within the last year there have been several fatal crashes (Hatfield, Ladbroke Grove, Paddington,

[12] Stephen Bailey Public sector economics 2002, page 353
[13] Stephen Bailey Public sector economics 2002, page 353

etc). After the *Hatfield Crash* Railtrack were forced to carry out emergency repairs to virtually the entire rail network (this crash was caused by a broken rail), creating obvious delays for the passengers. Unfortunately the financial situation of Railtrack is now in jeopardy, as it has incurred massive losses from fines paid to TOC's (for creating delays on the system due to temporary speed restrictions) and of course the massive costs of the maintenance work. Only time will tell whether Britain's Railways are guaranteed a secure future.

The basis of this assignment was to answer the question does privatisation necessarily increase efficiency? In answering this question this assignment has highlighted the main reasons for privatisation as a replacement for nationalisation. This assignment has compared the efficiency case for nationalisation with the efficiency case for privatisation. An examination took place on the privatisation of the former nationalised industries such as the British railway system, whicj highlighted the positive and negative changes that have taken place due to privatisation. In conclusion it is fair to say that depending of on the nature and market of service efficiency can be increased when privatisation has taken place. The concept of competition, which has appeared throughout this assignment, is a clear and effective way of increasing the efficiency of a service regardless whether it is in the public or private sector.

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