PRESSURE GROUPS AND POLITICAL FORCES IN BRITAIN’S PRIVATISATION PROGRAMME

COLIN ROBINSON

Professor of Economics, University of Surrey

Editorial Director, Institute of Economic Affairs

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1. The Paradox of Privatisation

Britain's privatisation programme of the 1980s and early 1990s is regarded in most countries as an exemplar of economic reform. It was indeed a pioneering effort, drawing on the intellectual capital provided by a counter-revolution in economic thought which demonstrated the advantages of economic liberalism.[1] Privatisation decisively changed the direction of British industrial policy away from state ownership and subsidisation, returning to private hands the industries which had been nationalised by the Attlee government in the immediate aftermath of World War Two. It resulted also in a regulatory régime for utilities which is a considerable improvement on the earlier US model. The British system - based on independent

[1] See, for example, Richard Cockett, Thinking the Unthinkable, HarperCollins, 1994.

regulatory offices, RPI - x price control and pro-competition action - is much less prone to 'gold-plating' and to 'capture' by pressure groups.[2]

Nevertheless, there is an apparent paradox in Britain's privatisation programme. It was carried out by an administration which proclaimed the virtues of market liberalisation. Yet liberalisation was not one of its main features: the emphasis was on ownership transfer.

It is true that, by privatising, government disengaged and allowed entry to markets which had previously been closed to all but state entities. Moreover, it exposed some of the privatised companies (though generally after a period of protection) to the rigours of the market for corporate control. In other words, it established some of the necessary conditions for competitive product and capital markets to flourish. But each of the bigger privatisations - particularly the utilities such as telecommunications, gas, electricity and water - when investigated in detail appears a somewhat timid step which did little in the early years to liberalise the relevant product or

2 Colin Robinson 'Introducing Competition into Water' in M.E. Beesley (ed), Utility Regulation: Broadening the Debate, IEA Readings No.46, London, Institute of Economic Affairs, 1997.

capital markets. [3] Typically, incumbents - the successors of dominant state corporations - were left with substantial market power and for many years consumers were denied the benefits which arise when they have the power of exit from suppliers. Most of the genuine product market liberalisation which has occurred is a consequence of action by industry regulators (armed with pro-competition duties) and the Monopolies and Mergers Commission, rather than of the original privatisation schemes.

The paradox cannot be resolved by neo-classical economic analysis: an omniscient and altruistic government acting in the ‘public interest’ would not have privatised in the way British governments did. It would have acted decisively to establish rivalrous product markets and to move the privatised companies into the market for corporate control.

Only by using the insights of public choice analysis can one understand the form of the privatisation programme. But the underlying paradox then

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3 Critiques of the privatisation schemes and subsequent regulation are to be found in a series of IEA papers - Regulating Utilities: The Way Forward, Readings No. 41, London: July 1994; Utility Regulation: Challenge and Response, Readings No. 42, London: June 1995; Regulating Utilities: A Time for Change? Readings No.44, London: May 1996; and Regulating Utilities: Broadening the Debate, Readings No. 46, London, July 1997.

turns out to be different from the one first stated. It is that privatisation, though an act of political disengagement, is at the same time itself a political act. Consequently, it is subject to all the failures and unintended consequences generally associated with political action.

2. Pressure Groups and Policy-making

One of the principal insights of public choice theory is that, between elections, government policies are heavily influenced by producer pressure groups: hence the tendency for policies to be swayed by organised producers rather than by (generally unorganised) consumers. Producer groups expect high returns from lobbying because favours they receive from government will be concentrated on their members whereas the costs will be spread thinly over the community as a whole. Consequently, they have an incentive to invest substantial resources in such lobbying. An event such as privatisation provides producers, both in the industry concerned and in associated industries, with a one-off opportunity to make gains for their members. Thus they are likely to make a determined effort to influence government privatisation policy.

The theme of this brief paper [4] is that the structures of privatisation schemes in Britain were determined primarily by the interplay between pressure groups and government - the latter being the most powerful group of all since it has unique powers of coercion, including the power to tax, and enjoys a monopoly (between elections) in the supply of policy. The paper assumes government is primarily a vote-seeker which treats citizens unequally, favouring those groups which appear able to deliver or influence large numbers of votes. [5]

In the final section of the paper there are some comments on problems which have arisen from politicised privatisation schemes.

3. Political Benefits and Privatisation

Since privatisation is a policy supplied by government, to understand the conception and execution of privatisation schemes the relevant starting point

[4] A more extended discussion is in Colin Robinson, 'Deregulating the British Energy Industries: The Lessons to be Learned', Metroeconomica, 1-2, 1992.

[5] In practice there are constraints on political behaviour imposed by the need to appear to be pursuing the 'public interest; by the tempering role of the civil service; and by the requirement occasionally to put policies to the electoral test. See Robinson, Metroeconomica, op.cit.

is take the viewpoint of the politician and then enquire what potential benefits he or she will perceive.

In Britain political rhetoric had it that privatisation was for the benefit of the consumer so the emphasis was to be on much enhanced product market competition. But were politicians concerned about benefits to consumers? Or were their actions determined principally by their perception of short term political advantage? There was never any clear statement of the aims of the privatisation programme [6] - indeed, there was never a ‘programme’ in the sense of a carefully considered plan. Even if there had been a statement, it is of course most unlikely Ministers would have said they were pursuing electoral advantage. The dominant objectives have to be inferred.

4. Aims of Privatisation

Those objectives appear to fall into four categories: widening share ownership, raising revenue, depoliticisation of decisions in the industries concerned and market liberalisation. The first two objectives were vigorously

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6 One of the few discussions of the privatisation programme by a government Minister is in a speech in 1985 by Mr John (now Lord) Moore, The Success of Privatisation, HM Treasury Press Release, 107/85.

pursued, presumably because they seemed to offer early and sizeable political benefits.

Share ownership in Britain was widened, though not deepened [7], by offering the public shares in the privatised corporations at prices generally at a substantial discount to initial market valuations. In addition, employees and customers were given special deals and applicants for small numbers of shares were favoured: the aim was evidently to spread the available shares over a large part of the population. An opportunity was presented which appeared irresistible to many - either of buying privatisation issues and then selling quickly in order to realise a cash handout from the state or of holding the shares and feeling wealthier. The bigger schemes, starting with British Telecommunications in 1984 and continuing with gas, water and electricity into the early 1990s, were well-publicised and very popular. There can be little doubt that they brought a return in terms of increased votes for the

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[7] In the three years after the British Telecom sale in 1984, the proportion of the adult population which owned shares increased from 7 per cent to 21 per cent (though not all the increase was attributable to privatisation). In 1992, the percentage was 22. However, in the 1980s, the proportion of UK company equity held by individuals was declining – from 28 per cent in 1981 to 21 per cent in 1992. See 'Biggest expansion in share ownership since 1987', The Financial Times, 13 December 1989; 'Lamont seeks share ownership in depth', The Financial Times, 15 May 1991; and 'Share ownership: risk aversion', The Economist, 6 November 1993.

Conservative Party and were one of the factors behind its ascendancy in British politics from 1979 to early 1997.

At least as important as widening share ownership was revenue-raising. In the 1980s, there were signs that governments in many countries were running up against the limits of taxable capacity. Yet, despite high tax rates (or because of them), governments could not raise enough via taxation to finance all the spending they thought desirable. Increasing state borrowing was becoming a serious economic problem.

Consequently, governments were seeking ways of raising revenue without increasing taxes. In Britain, privatisation offered an apparently painless means of raising large revenues and applying the proceeds to the reduction of public borrowing and the lowering of interest rates which seemed very desirable political objectives, especially in the early- and mid-1980s. [8]

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8 The total revenue raised by British privatisation schemes since 1979 is nearly £70 billion.

The third objective (reducing politicisation) tends to be an objective of all privatisation programmes or, if not an objective, a consequence. Extensive interference by politicians was a feature of the nationalised industries in Britain. [9] In electricity supply, for example, the nationalised industry was induced by government to buy more British coal than it wanted, to build British-designed nuclear power stations and to buy British generating and other equipment. [10] Such interference becomes much more difficult once companies have private shareholders.

Objective four - product market liberalisation - is the one to which most economists would accord priority [11] on the grounds that opening to competition markets long monopolised is the most likely source of gain from

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9 David Heald, The Economic and Financial Control of UK Nationalised Industries, The Economic Journal, June 1980.

10 Colin Robinson, Energy Policy: Errors, Illusions and Market Realities, Institute of Economic Affairs, Occasional Paper No. 90, 1993.

11 The article by Michael Beesley and Stephen Littlechild which laid the intellectual basis for privatisation argued that ‘The promotion of competition...is the most effective means of maximising consumer benefits and curbing monopoly power.’ See Michael Beesley, and Stephen Littlechild, ‘Privatisation: Principles, Problems and Priorities’, Lloyds Bank Review, July 1983.

privatisation. [12] But the evidence suggests it came low on the government's list, despite the lip-service paid to it at the time of each privatisation. To politicians, the social benefits from increased competition appeared intangible and, in any case, such benefits would not be realised within the normal political time-scale. Before embarking on a policy, politicians must perceive that there are likely to be many more winners than losers. Moreover, the winners must realise that they are winners so that they can repay their gains with votes. Thus there is an inherent bias against competition-promoting policies simply because it is often difficult for people to recognise that they have won. Benefits, even if large for society as a whole, may be thinly spread. Moreover, they may not readily be identifiable with the originating action, both because they take time to appear and because they will be in comparison with what would otherwise have happened rather than with recent events.

Such reasons seem to be behind the half-hearted pursuit of product market liberalisation in British privatisation schemes. [13] Nor were the capital markets allowed to operate freely. Typically the government held a 'golden

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12 It is, of course, possible to liberalise without privatising -for instance, allowing coal to be imported freely was an important liberalising measure in the British coal market before the industry was privatised.

13 Robinson, Metroeconomica, op.cit.

share' which allowed it to block anyone from owning more than 15 per cent of a privatised company's voting share capital. [14]

5. Conflicts Among Objectives - and the Power of Pressure Groups

Execution of the British privatisation programme demonstrates a common problem in economic policy-making. Since policies are executed by politicians, where conflicts in objectives arise those objectives which have the biggest expected political returns (often because they are supported by strong pressure groups) can be expected to predominate.

In the case of privatisation, there were a number of possible conflicts. For instance, there was some tension between the wider share ownership and the revenue-raising objectives: the incentives offered to buy shares and the limits on individual ownership to ensure that shares were widely spread probably meant that revenues to the government were not maximised in most big privatisations.

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[14] The government did not exercise its veto in the cases of the Ford takeover of Jaguar and the BP takeover of Britoil. Some of the golden shares were time - limited: those in the Regional Electricity Companies, for example, expired early in 1995, following which there was a spate of takeover bids.

However, the principal conflict was between the wider share ownership and revenue-raising objectives on the one hand, and market liberalisation on the other.

As explained above, the first two objectives appeared very attractive in political terms but the government probably anticipated that the immediate political gains would be significantly reduced if markets were liberalised. A common view at the time was that the more a product market is liberalised, other things equal, the worse the earnings prospects for the companies concerned, the less appealing the shares and the smaller the revenue likely to be raised from flotation. [15] Market liberalisation thus seemed likely to compromise the share ownership and revenue-raising objectives.

Other powerful groups held anti-liberalisation views congruent with those of government. For example, at the time of each major utility privatisation, senior management of the corporation concerned - which stood in a key position because it could significantly delay, or even scupper a scheme which it perceived not to be in its interests - wanted the greater

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[15] Colin Robinson, Liberalising the Energy Industries, Manchester Statistical Society,1988.

freedom and higher salaries which privatisation brings. But, at the same time, it wished to retain the market power to which it had become accustomed during many years of nationalisation. [16] Without exception, managements of the utilities opposed any form of break-up or the specific introduction of new competitors.

So far as one can tell, civil servants in the ministries which had sponsored the nationalised industries - most of whom had been to some extent captured during the years of state ownership - supported incumbent managements in their opposition to liberalising measures. The industry's unions also opposed the introduction of competition, doubtless because they expected to be able to conclude much cosier arrangements with a monopoly than with a firm operating in competitive conditions. Both managements and unions favoured golden shares which would restrict takeovers so as to give them quieter lives than they would otherwise enjoy. Another important group - the government's financial advisers - though not favouring restrictions on

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[16] The prime example of how a corporation can influence the privatisation scheme is the British Gas privatisation in 1986 when company management apparently only acquiesced to a speedy privatisation on condition that British Gas was transferred into the private sector with its market power intact. See Colin Robinson, 'Gas after the MMC Verdict', in M.E.Beesley (ed), Regulating Utilities: The Way Forward, Institute of Economic Affairs, Readings 41, 1994.

takeovers, also preferred to float companies with product market monopolies (provided they were only lightly regulated) rather than firms in a competitive industry: they perceived it to be easier and (because of the expected higher revenues) more profitable.

6. The Inherent Illiberality of Privatisation Schemes?

Thus, at the time of each major privatisation, there was a coincidence of interests among all the powerful pressure groups. Politicians wanted to raise large sums quickly and to extend share ownership. To do so, they needed the help of incumbent managements, key civil servants, the unions and the financial markets all of which had interests in minimising the degree of competition faced by the newly privatised corporations. Product market liberalisation had a low priority because there was no organised constituency which supported it: on the contrary all the organised groups were against.

This view might suggest that, in representative political systems, privatisation schemes will always tend to be illiberal because it will invariably be in the interests of the most important pressure groups that they should be so. That may well be true. [17] However, British experience also suggests that the outcome of the political calculus is more complex. There is a further stage beyond the implementation of privatisation schemes in which pressure groups play an important role - but at this time it is more benign.

7. Retrieving benefits for consumers

After the flotation, theory indicates that the original unholy coalition against liberalisation is likely to disband. Certainly it did so in Britain after each privatisation scheme had been implemented. An alliance of producer groups, politicians and bureaucrats held together only by a dislike of competition-promoting policies inevitably loses its cohesion once the government has raised its revenue and widened share ownership, company management has accomplished its goals, unions have collected privatisation 'perks' for their members and the financial advisers have been paid their fees.

Furthermore, new pressure groups in favour of competition can be expected to emerge as the effects of private monopoly become apparent. Companies have inputs as well as outputs and those which purchase the

[17] See Colin Robinson, 'Privatising the Energy Industries', in C. Veljanovski (ed.) Privatisation & Competition, Hobart Paperback No. 28, London: Institute of

goods or services of the newly privatised corporations are likely to express their discontent if prices do not fall and service does not improve. Small consumers are unorganised, which is why their interests receive little attention. But large companies and trade associations have considerable lobbying power which they will use when their interests as consumers are affected, just as they will when their interests as producers are concerned.

Britain's experience confirms that producer groups, acting in the role of large consumers, will move into the pressure group vacuum created by the departure of the unholy coalition. The power of such groups has been particularly noticeable in the privatised gas and electricity markets [18] : in the case of gas, British Gas - which had been transferred to the private sector in such a way that it seemed likely to be dominant for many years [19] - was

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Economic Affairs, 1989 Second Impression, May 1992.

18 See Robinson 'Gas: What To Do After the MMC Verdict', op. cit. and 'Profit, Discovery, and the Role of Entry: Applications in Electricity', in M.E.Beesley (ed), Regulating Utilities; A Time for Change?, IEA Readings No.44, Institute of Economic Affairs, 1996.

19 The company was vertically integrated, owning the pipeline network, supplying all consumers of piped gas in Britain and having under contract all North Sea gas supplies which had then been developed.

referred to the Monopolies and Mergers Commission (MMC) within a year of privatisation at the instance of industrial consumers. [20]

In electricity, though there has been no comparable reference, industrial consumers - concerned that competition has spread so slowly - have been vocal critics of the electricity companies. In both industries, complaints from big consumers have been powerful influences on government and on industry regulators left with the task of trying to retrieve for consumers the benefits of privatisation. An unusual feature of Britain's utility regulation regime is the duty it imposes on regulators to 'promote' or 'facilitate' competition. [21] Regulators, whose performances are judged partly on their success in encouraging competition, and large consumers have therefore been natural allies in liberalising utility markets.

8. Some Policy Consequences

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20 The MMC report was published as Gas, Cm.500, HMSO, 1988.

21 The wording of the duty varies from industry to industry. The weakest statement ('facilitating') is in the water industry where it was thought at the time of privatisation that there was little scope for competition.

This paper has been concerned so far to apply positive public choice theory to explain why British privatisation schemes took their particular forms. It has argued that privatisation schemes were political acts and consequently were designed principally to achieve political aims. When schemes were being formulated, neither government nor the principal interest groups favoured competition. Only when powerful pressure groups which had an interest in competitive markets began to emerge post-privatisation did product market liberalisation gain impetus. To conclude, it is worth describing and commenting on some of the consequences (mainly unintended) of these relatively illiberal privatisation schemes.

On a long view, it might not seem to matter that privatisation schemes were dominated by political objectives. Such schemes will reduce politicisation and make chinks in the barriers which previously prevented entry to industries monopolised by state corporations. Entry may be difficult but it will no longer be impossible. Thus potential entrants can exercise their ingenuity in surmounting the remaining obstacles and unleash the forces of

Schumpeterian 'creative destruction' [22] on remaining monopolies to the benefit of the privatised companies' customers.

That view assumes that political obstacles will not preclude achievement of these potential long run benefits. It would be a perfectly reasonable line to take if political intervention in the privatised industries were no longer possible. Market forces, once unleashed, would eventually prevail. If, in particular, as presently planned, even the smallest British energy consumers are permitted to choose gas and electricity suppliers from 1998 onwards and political interference with these markets is avoided, it is likely that the benefits of liberalisation will from then on flow quickly to consumers, leading to falling prices and improving service standards. But there are some dangers of re-politicisation in the present situation in Britain where, in contrast to the 1980s, opinion surveys indicate privatisation is no longer popular with the electorate.

The most likely reason for this unpopularity is the contrast between the expectations of the results of privatisation which government encouraged and

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[22] Joseph Schumpeter, Capitalism, Socialism and Democracy, London: Allen and Unwin, 5th Edition, 1976, especially chapter VII.

the outcome. Public pronouncements at the time of each privatisation which emphasised the likely benefits to consumers led to inflated expectations from schemes which initially did little to liberalise markets. Incumbents were left with significant market power in potentially competitive sectors (such as electricity generation and supply and gas supply) and so regulators had to intervene to protect consumers. As a direct consequence of illiberal privatisation schemes, the scope of regulation became far wider than the 'natural monopoly' networks of wires and pipes. In electricity, for example, the regulator has been much occupied in regulating generation which is a potentially competitive market. Given that regulation is always and everywhere a most unsatisfactory substitute for competition, [23] the very wide scope of British regulation is a particularly serious problem.

Because regulation will not bear the weight which has been placed on it, consumer dissatisfaction with privatised companies (especially the utilities) has grown and is being translated into disillusionment with privatisation itself,

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[23] A good discussion is in Israel M. Kirzner, 'The Perils of Regulation: A Market Process Approach', in Discovery and the Capitalist Process, University of Chicago Press, 1985.

despite the efficiency gains [24] and the improvement in services which have been delivered in most of the privatised markets. Because of the weakness of competition in the early years, these substantial efficiency gains have not been passed on to smaller consumers: instead the principal beneficiaries have been shareholders, senior managers and (recently) large consumers with lobbying and bargaining power. A particular problem has been the big salary increases paid to many senior managers (‘fat cats’) which have been headline news in Britain.

Given the circumstances, there is a danger that the wheel will come full circle so that, before long, a situation similar to nationalisation will again prevail as the relevant markets are re-politicised. Politicians who observe that privatisation is no longer popular and can see obvious targets, such as ‘fat cats’ and ‘undeserving’ shareholders, realise that there may be electoral advantage in re-regulation.

That is not to say state ownership is again on the political agenda. Britain’s New Labour government, though an opponent of privatisation in the

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[24] One of the most striking examples is in electricity generation where, seven years after privatisation, the two major generators have reduced their labour forces by

past, is now against re-nationalisation. However, to achieve control of the industries it does not need to re-nationalise. It could use the regulatory apparatus bequeathed by the Conservatives to gain control without ownership.

Because privatisation schemes left regulation with so wide a scope, relatively small changes to the rules (for instance, downplaying the competition-promotion objectives which utility regulators now have) and, if necessary, replacement of some of the regulators would quickly lead back to state control, if not state ownership. In the early days of the new government, the leaders of the privatised water companies were called together by the Deputy Prime Minister who exhorted them - in a way familiar from the days of nationalisation - to cut the leakage rate from their pipes and to help consumers save water. Annual (instead of five-yearly) leakage reduction targets are to be set and Mr Prescott promised a 'more hands-on approach', reinforced by legislation if necessary. [25]

over 70 per cent.

[25] 'Prescott gets tough on water leaks', The Financial Times, 20 May 1997.

It is, of course, very early to know what will happen under the new government. But if utility markets are re-politicised, many of the problems which used to plague the state-owned industries will re-emerge. Managers will not know whether to pursue commercial or vaguely-defined 'public interest' objectives, continual conflicts between privatised companies and the government are likely, some of the efficiency gains of privatisation might quickly be lost and the price benefits which are just beginning to appear would also be foregone.

9. Conclusions

The politicised form of privatisation in Britain is entirely understandable in terms of positive public choice theory. It is only to be expected that politicians will give political objectives top priority, relegating objectives which economists would favour. But government failure to place more emphasis on market liberalisation is now leading to consequences that were certainly not intended, especially in utility markets. The legacy of this failure is that many consumers have yet to see the benefits of liberalisation: a consequence is that pressures are appearing to re-politicise markets which had earlier been freed.

The outcome of this delicately poised situation is not easily predictable. Britain is on the verge of having genuinely competitive markets for the major utilities in which even the smallest customers will have the power of exit, so that prices are likely to decline and service standards to improve. The government can, no doubt, see the advantages of allowing these benefits to flow through to consumers. However, it has already shown that it also has instincts to interfere: it has all the regulatory apparatus to do so if it wants or it can over-ride that apparatus, as it has begun to do in water.

It may be that competition will continue to develop in British utility markets and will be flourishing in a few years' time. But a pessimist might claim that, despite Britain's pioneering role in privatisation, it could throw away the principal gains just as they were in sight of being realised. Whatever the outcome, there are lessons to be learned about the consequences of politicised acts - even those ostensibly directed at government disengagement - with their 'short-termist' emphasis. In the case of privatisation programmes, apart from the impact effect of such acts, they may later unleash forces inimical to the achievement of the competitive markets which are the most likely source of benefits from privatisation.

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Colin Robinson