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Winter Address 1992

PRIVATISATION EVERYWHERE

the world's adoption of the British experience

John Moore MP

CENTRE FOR POLICY STUDIES

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The author

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Acknowledgement

Support towards the publication of this pamphlet was generously provided by Hill and Knowlton International, to whom John Moore is senior consultant on privatisation.

ISBN 1-869990-20-X

Centre for Policy Studies, January 1992

Printed in England by Davlyn Design & Print
577 Kingston Road London SW20 8SA

Introduction

THE WORLDWIDE COLLAPSE OF STATE SOCIALISM has focused new attention on the workings of a free economy. Interest centres above all on how the huge range of industries presently languishing in state control around the globe can be successfully transferred to private ownership.

The process called 'privatisation' was pioneered in Britain over ten years ago. A radical experiment at the time, it is now a practical, proven process by which state-owned industries can join the free market with visible and often dramatic gains for the industry, its employees, its customers, and for the Government that set them free.

The lessons we in Britain learned -- sometimes painfully -- in the pioneering years of privatisation are relevant to all the countries currently struggling to transform stagnant state-dominated economies into dynamic, free-market ones.

The time has come to report on the decade of privatisation in Britain: why we did it, the problems we faced, the radical new ideas and processes that had to be designed to overcome these problems -- not least the inevitable conflict between political and commercial priorities -- and finally, why this process has proved so powerful in helping to halt and reverse what looked, in the 1970s in Britain, to be terminal decline.

1.

Why privatise?

When the Conservatives took office in 1979 we inherited an economy in serious trouble. It had been deteriorating for many years, but in the 1970s the decline accelerated. We were convinced a major cause was the extent of government control over industry. We believed this not because of some sterile ideology as was alleged at the time, but because we saw then what the collapse of socialism has now made so apparent: that state-owned industries will *always* perform poorly, and this poor performance will badly affect the economy as a whole.

State control in Britain was not, of course, as extensive as in the command economies of Eastern Europe, but it was sizable: since World War II successive Labour governments had nationalised the coal industry, the steel industry, electricity generation, gas supplies, the railways, docks, canals, road haulage. Virtually all the telecommunications industry was government-owned, as was aircraft and ship building, much of car manufacture, North Sea oil, and even silicon chip manufacture.

The performance of these nationalised industries was characterised by poor, and in some cases negative return on capital, low productivity, high costs, high prices, bad labour relations, inefficient use of resources, and inadequate and unsatisfactory service to customers.

It must be stressed that the reasons for this did not lie in the quality of the workforce. There were people of talent and energy at all levels of the nationalised industries. The reasons for poor performance lay instead in the nature of state ownership itself. It is important to set these reasons out, because although there are some people for whom they are too obvious to need re-stating, in countries where the public sector culture has been dominant they have often never been expressed.

Poor performance in state-owned industries is inevitable because:

1. The priorities of elected politicians are necessarily different

from the priorities of effective business managers and can only rarely be pursued simultaneously. Usually they are in conflict. In state-owned industries the politicians, as 'proxy owners', are in charge and so their priorities take precedence over commercial ones. In the long term this damages the commercial viability of the company.

The different, often conflicting, objectives of politicians and business managers mean that politicians find themselves involved in what should be management decision. They may override commercial judgments for instance, in order to site a new plant in an electorally sensitive area, or refuse to close an uneconomic one. They can become involved in hiring policies and the size of the work force. Political timeframes are governed by elections, are often incompatible with the longer time cycles business needs.

This is not to say that political objectives are not perfectly legitimate -- they are. Matters affecting employment, for instance, are proper concerns for elected politicians. But if a concern for jobs overrides a need to remain competitive, it can damage the industry and cause more job losses in the long run.

Politicians have found it particularly difficult to resist interference in the pricing policies of nationalised industries, with periods of artificial price restraint (in aid of misplaced counter-inflation strategy) followed by the inevitable painful period of catch-up.

Even more damaging is the fact that political intervention can in some cases distort the true market position, with serious consequences. A good, grim example was in the early 1970s when the British Gas Corporation bowed to political pressure -- to try to avoid the effects of the OPEC oil shocks by artificially holding down domestic prices. But because of the government-inspired decision on gas, the competitive position of electricity, especially for off-peak sales, suffered badly. This worsened the problems both of excess capacity in the electricity industry, and of the coal industry's surplus production and stocking. Gas shortages developed, at times forcing the BGC to turn away new business in industrial markets and adding to the pressures to import more gas. Domestic consumers contributed to the problems by changing from electric night-storage heaters to gas not realising that no government could afford to let the industry sustain the artificially low gas price indefinitely. The subsequent, inevitable, catch-up period on gas prices was painful indeed. This is just one example of the unavoidable consequences of political interference in what are rightly management decisions. There are many more.

Conflict between commercial and political objectives is particularly visible in the financial dealings of nationalised industries. One of the more important jobs of an elected politician is to try to ensure the prudent and proper use of public money -- which is, of course, simply the money the government has taken away from people in taxes.

There is a limit to how much any government can take in tax, and so there is always a limited amount of public money. This means there are constantly hard choices to be made on how and where it is to be spent. The claims of state industries for capital investment, which may be absolutely justifiable in commercial terms, are weighed by politicians against the demands for new hospitals, schools, public transport, roads, and all the other electorally popular claims on public money.

Not only are the nationalised industries often far back in the queue for government money, because they are state-owned they are restrained from looking elsewhere for finance. As part of the public sector their borrowing is underwritten by the Government and is indistinguishable in market terms from other forms of public sector borrowing. Therefore it is a significant component of the Public Sector Borrowing

Requirement. The politician's first priority must be to the economy as a whole, and there are inevitably times when the needs of individual state industries are subordinated to macro-economic requirements and their ability to borrow must be curtailed.

Even more restricting, in terms of the industries' ability to innovate and grow, is the fact that simply because they are owned by the state they can never attract genuine risk capital. It is no answer to say 'let's pretend the industries are not in the public sector'. Financial markets and through them investors understand the reality and will not choose to put risk capital where it cannot reap the rewards of true equity ownership. Thus nationalised industries' financial flexibility will always be constrained.

When state-owned industries do become private and gain access to the wider capital markets, they receive yet another impetus to improved performance. There is intense competition for risk capital and any company wishing to attract it has to survive the scrutiny of analysts and financiers, who are experts in judging how effectively a company uses its resources. How efficient is its plant, they ask. How high its productivity? How good is it at using its employees and satisfying its customers? In order to appeal to investors a company needs positive answers to all these questions.

2. The second reason why state-owned industries perform poorly is the plain if unpalatable fact that a nationalised industry does not have to succeed to survive, and everyone in it knows it.

Nationalised industries are dependent on the government for their survival, not the market. What is missing is the spur that drives private industry to respond to consumer demands, to innovate, to increase productivity and improve efficiency. That spur is not just the hope of greater rewards -- although that is the up-side -- it is also the ever present possibility of failure. This is what the phrase 'discipline of the market' actually means: the chance you can go bankrupt, broke, out-of-business, 'belly-up'. All harsh terms for a harsh reality, but it is that discipline which has proved over and over to be a key factor behind successful industries. When throughout an industry it is known that the government will always pick up the bill the result is too often inertia, inefficiency, and little attention paid to the needs and wants of consumers.

To take just one example: Before privatisation the British Gas Corporation was the only place you could buy a gas cooker. BGC had a total monopoly on the retail sale of this kind of appliance. So little did they understand the nature of selling to customers that their retail outlets were not even listed in the telephone directory.

In a nationalised industry there is no incentive to serve the customer -- no reward for doing it well, and no punishment for doing it badly. One does not need to be a cynic about human nature to predict the outcome.

3. The third reason why nationalised industries perform poorly is, I think, the most important: it is that the basic philosophy of state ownership denies and therefore fails to harness positively the power of self interest.

Self interest is not some evil attribute to be repressed, it is simply the urge that people have to improve their lot in life, both for themselves and their families. It has been the engine of progress since the dawn of time, and to pretend otherwise is to ignore one of the most powerful forces available for improving the quality of life for everyone.

In the private sector the self-interest of employees and managers is harnessed to the satisfaction of customers. For a business to survive in competitive markets that satisfaction requires the most efficient use of resources.

The philosophers of the public sector have always explicitly denied self interest as a motive for employees and managers in nationalised industries. The socialist politician Herbert Morrison wrote in 1933 that the attitude of the officers of state-owned industries must be 'to regard themselves as the high custodians of the public interest.' As with the ascetic Guardians of Plato's Republic (who were indeed invoked in debates of the period), vulgar notions of profit and personal success simply should not arise.

But you cannot abolish self interest by denying it. It still exists in the managers of state-owned industries, who quite naturally want their organisation to grow and thrive. But in a nationalised industry that outcome is not dependent on satisfying customers, it is dependent on satisfying the policies of government. Managers therefore direct their attention towards the government, which responds to the managers' concerns in a closed circuit in which the customer does not figure: the whole operation is geared towards the need of the producer rather than of the customer.

In a producer-oriented culture market signals are not given the importance they deserve, and the industry's competitive position inevitably deteriorates. Markets are not static even if producers are, and customers' patterns of behaviour change in favour of producers who best satisfy their existing wants and most accurately anticipate the new ones. In this situation producer-oriented nationalised industries find their share of the market dwindling and their usual reaction is to make more and more urgent demands on the government for increased investment, subsidies, and plain hand-outs.

Moreover, when the nationalised industries occupy such a dominant position in a nation's economy, producer-oriented, government-directed attitudes spill over into other sectors. I remember a startling experience at the beginning of the Conservatives' first term in office, in 1979, directly after

> we had campaigned and won on policies emphasising enterprise, the free market, and less state involvement in industry. Despite this, one of the first visits I had as Minister for Coal was from the Association of Mining Equipment Manufacturers. Mining equipment companies were not state-owned, but they supplied the state-owned coal industry and the purpose of the visit was to press for increased government subsidies to that industry so that it could buy more of their equipment. It illustrated how much of the business community at that time, in the private as well as in the public sector, directed its selling efforts at the government not the market.

These three factors, which are the root causes of the poor performance of nationalised industries -- subordination of commercial to political objectives, survival not dependent on success, and a producer-oriented culture -- cannot be altered as long as the industries remain in state ownership. The only proper answer is to privatise them, as we have done and continue to do.

The results justify our confidence in the process. Many excellent books have been written about the performance of various industries following their privatisation. Space allows for a few representative examples only:

In 1979 the annual borrowings and losses of the state-owned industries were running at over £3 billion. Compared to that £3 billion they were costing the Exchequer in 1979, the privatised companies in 1989/90 gave to the Exchequer £2 billion in tax receipts; £1.5 billion CT, and the remaining half-billion from dividends and interest.

Although they were not the major reason for putting the companies into private hands, the receipts of the sales were far from negligible. £34 billion has been received to date, and this, along with the dramatically improved economy as a whole, made it possible to transform the Public Sector Borrowing Requirement into a Public Sector Debt Repayment, and to re-pay over a two year period 12½ percent of the national debt,to the immense benefit of future generations who will have that much less debt to shoulder.

The performance of the newly private companies has justified our confidence in other areas such as labour relations and customer service -- for example the public pay-telephones, the call boxes, provided by British Telecom. It was hard to find one working. The published figure in the 1980s was that 75 per cent were 'operational' although people looking for one in urban areas would probably dispute that. The fact now is that *97 per cent* of public call boxes work, and there are many more of them. Moreover, there is no longer a waiting list -- as there always was pre-privatisation -- to have a telephone line installed, and BT's main service to customers now costs less by 22½ per cent in real terms.

The British experience demonstrates beyond doubt that privatisation improves the performance of former nationalised industries, and encourages the more efficient use of resources throughout the whole economy. But the British experience also shows that there are two other, in many ways equally important, arguments, reasons for privatisation.

One is the extension of individual ownership and the transformation in attitudes it produces. The other is the way the process forces politicians to think through and focus on the state's true rôle as regulator, not owner, and thus make it become a more effective protector of the public interest.

2.

The power of ownership

It would have been possible in theory to privatise state-owned industries in Britain without extending direct equity ownership to the millions of people who have in fact bought shares. The industries could have been sold to the big institutional investors who formerly made up almost the whole of the British equity market.

But spreading ownership as widely and deeply as possible was an integral part of the British privatisation policy, This was because we believed that wider share ownership would bring about a dramatic transformation in attitudes throughout the country. And it has.

Take the visible change that comes over workers in an industry who become its part owners through an employee share ownership scheme. One interesting example followed the management/employee buy-out of the National Freight Company. Charts went up in all the NFC depots around the country showing the movement in the share prices. During wage negotiations the new employee-owners actually pressed their union to lower the wage demand because they were concerned about the profitability of *their* company.

Actual ownership -- private property -- changes attitudes and behaviour. When people have a personal stake in something they think about it, care about it, work to make it grow and prosper. Ownership means the exercise of responsibility, and the possibility of choice. It teaches the finiteness of resources, the virtues of thrift, and the risks and rewards of investment. Most of all ownership increases independence and the power an individual has over his own life.

The issue of ownership reveals the fundamental difference between those who seek to concentrate power, wealth and decision making into the hands of the state, and those who believe in spreading these things throughout the community in order that more and more people should have a genuine stake in it.

One of the more revealing aspects of the privatisation process in Britain was the bitterness with which those opposing it resisted attempts to spread ownership. The attacks on privatisation included such accusations as 'selling the family silver' and other implications that people were being robbed (of something they already owned!). Trade unions in particular tried to dissuade their members from buying shares in the companies in which they worked. But without exception employees of nationalised industries responded to the offer of shares with enthusiasm. At British Aerospace 89 per cent of the eligible work force took up shares. At Associated British Ports it was 90 per cent. At British Telecom 96 per cent. At Amersham and Cable and Wireless 99 per cent.

People *want* to own things, and they are entirely sensible of the value of equity share ownership as a flexible capital asset. For most people this may not be a large one; but it does represent for the first time an alternative source of earnings, and so lessens the total reliance on a single wage packet which has meant such a frightening dependency for many people.

We made it clear from the start that the extension of ownership was an important part of the privatisation programme, and so it is satisfying to report that the tiny group of individual share holders in 1979 -- barely 7 per cent of the population -- has grown to over 25 per cent: one in five people in Britain now own shares in their own name.

The question of personal ownership is of even greater importance for former socialist and communist states, where individuals have never owned assets like citizens of free countries. If I were advising any nation, but *particularly* an ex-socialist one, I would recommend that the widest possible extension of individual ownership should occupy the centre of the stage, in order to exploit the unrivalled power of privatisation as teacher of the responsibilities and rewards of a free society.

But I would also advise against accepting the proposal that will probably be made to *give* shares away free. This suggestion is repeatedly put forward as a quick way to put public industries into private hands with a minimum of fuss. But is misses the point Thomas Paine made long ago at the time of another famous revolution, that 'what we obtain too cheap we esteem too lightly'. In order for the far-ranging benefits of individual ownership to be achieved by owners, companies and countries, individual people need to make the actual decision to buy and to commit some of their own resources to the choice.

3.

The proper rôle of the State

Privatisation forces everyone involved to focus on the state's proper rôle as the *regulator* rather than the owner of industries. In this rôle the politician can become a better protector of the public interest, and this shift in attitude throughout government is of profound importance.

When government is the owner, government's problems predominate. Look at the pattern of Parliamentary debates in the forty years after the War, throughout the period when nationalisation was at its peak, and it is clear that the debates on industries all focus on *owner's* problems: the industries' losses, their investment needs, their debts, their labour relations, strike records. Nor is surprising. The pressures on the state-as-owner are immediate and. (Should this shipyard in an area of high unemployment be closed? How can we get more money for investment? How can this damaging strike in the car industry be settled?) The obligations to protect consumers are longterm and diffuse -- individual customers complains generate much less urgency.

More than just the debates, the entire Parliamentary process, and indeed government itself, was focused on *industries'* problems and how to resolve them. It could not be otherwise when Departments were the sponsors of companies. Individual Ministers had to be the industries' champions against the Treasury; teams of civil servants worked full time dealing with their problems and arguing with their managers. Days and days of Treasury time were eaten up with discussions on EFLs -- the external financing limits of the nationalised industries.

As a Member of Parliament, when an individual had a problem with a nationalised industry and brought it to me (as to any M.P.) the procedure was to take the matter up with the responsible Minister or directly with the Chairman of the industry, who would usually respond that his industry could not meet this individual's particular need or problem because it was hamstrung by the stinginess of government in terms of investment/subsidy/expenditure. Ministers then usually felt compelled to defend the Government's spending record, and the debate proceeded along predictable lines, the individual's problem remaining unresolved.

All of this simply illustrates the self-evident truth -- an owner is more interested in his industry's problems than in its customers.

Contrast this with the position of watch-dog/regulator which is the one the state now performs. In this situation there is no ambivalence; elected politicians can act with vigour to protect their constituents' interests. Parliamentary debates are about service to customers, not the needs of the industries. My own experience has been that letters to the Chairman of privatised industries about constituents' problems receive answers directly aimed at the problem, usually with proposals for its resolution. Now when government is called upon to make decisions which will affect the industries it is the interests of consumers that most influence that decision. But would the Government as *owner* of British Airways have allowed United and Delta to fly into Heathrow and so sharply increase competition and customer's choice? Unlikely.

This shift from owner/provider to watchdog/regulator is of the greatest political significance. It created the climate in which the Citizen's Charter, with its focus on the users of public services, could be developed. It is important to note that the Charter reflects a cross-party consensus that the needs of customers should come first, which would not have been possible ten years ago. The Charter puts its emphasis on improving the provision of services for individuals; this will be achieved by further privatisation, by increasing competition and choice wherever possible (and where not, by increasing the powers of the regulatory agencies that work on their behalf), and by giving management greater freedom to manage.

The response to the Charter demonstrates that the argument in Britain about state versus private ownership of industry can be considered won by the latter. But as with all political issues, debate does not stand still. Controversy now centres on the state's rôle as watchdog/regulator, and in particular on the regulatory agencies set up to police the industries that were privatised -- one hopes temporarily -- as monopolies.

An important objective of the privatisation programme has always been to increase competition, because competition is the most effective spur to improving quality and service. It had therefore been thought originally that certain monopoly suppliers, specifically the public utilities, were not suitable candidates for privatisation. However the British experience has demonstrated that it is possible to disconnect the problems of state ownership from the problems of monopoly supplier and tackle them separately. Privatisation solves the problems caused by state ownership and wherever possible the process includes making the monopoly subject to competition. Where in the short term this is not possible mechanisms have been developed to stand as proxy for competitors and bring the effects of market forces to bear on the supplier. How these work comes next.

4.

Securing the 'national interest'

All governments wishing to move industries from the public to the private sector face specific anxieties most of which will be expressed as concerns for the *national interest.*

There will be, for instance, fears about foreign involvement and possible control; worries about protecting revenues and strategic supplies; questions about the company's post-privatisation behaviour (especially if a monopoly or semi-monopoly); anxieties about the continued existence of uneconomic but socially necessary services -- the list will be enormous, and virtually all the items on it will be presented as posing threats to the *national interest* should the industry or company in question be privatised.

Most of the issues that will be raised will be perfectly legitimate matters for the concern of a responsible government. The mistake made by those who raise them as obstacles to privatisation is to think they can be protected only if the state *owns* the industry involved. It is entirely possible for government to safeguard and defend any aspect of the industry it wishes to, either through provisions in the privatisation legislation, or simply through the use of normal government powers. Revenue is an obvious example where normal powers serve better than ownership: government does not need to *own* an industry for the nation financially to benefit from it; they can simply tax it.

A democratic government which correctly decides that ownership of industry is inappropriate has in no way abdicated its rôle or its responsibilities as guardian of the public interest. In a free society democratically elected governments make and enforce the laws within which the society operates: this, not ownership, is their proper rôle.

Analysing the validity of *national interest* is essential. Often the scrutiny will reveal, as in the case of revenue and tax, that ordinary government procedures can answer the concern. When not, the solution used in Britain is sharply to define the concern, and vest the protection of it in a 'special share' held by the relevant Secretary of State.

One example: when we were privatising Amersham, a sophisticated firm supplying radioactive products for use in medicine and industry, we recognised that it was unique. There was legitimate concern about a possible immediate takeover. So we put into Amersham's Articles of Association a time protection factor -- that was, simply, that Amersham could not be taken over for at least five years from the date it was privatised. We could have made such a time factor of any length, or even unlimited, if it had been thought necessary in the national interest. The 'special share' which was part of the share capital of Amersham was held by the Secretary of State for Trade and Industry. It carried the right, and only the right, to prevent any one person or group from gaining more than 15 per cent of the voting share capital in the company.

It is important to stress that the special share, or 'Golden Share' as it has become popularly known, is always tied to one or more specific provisions in the company's Articles of Association. It does not carry voting rights and it does not mean that the government retains any kind of ownership in the company or industry. Nor does it give the government control over the company's activities except in the specified area, or confer any right to interfere in management decisions. But it does protect the particular matter that has been defined as of *national interest*, and is a mechanism that can be used to answer any concern raised under this heading.

The 'special share' has proved to be an effective way of answering concerns about issues of *national interest* in the British privatisation programme. Its success is one illustration of why it is necessary to pass individual legislation for each privatisation, a fact that is not always fully appreciated. Some countries have tried to pass an omnibus bill under which all state owned industries could be transferred to the private sector. But this is not a satisfactory way to proceed. Such bills are hopelessly unwieldy in parliamentary terms -- one in Taiwan was mired in the legislature for two and a half years. More serious is the fact that a catch-all bill cannot allow for the specifically tailored provisions that a successful privatisation requires. Legislative scrutiny of each proposed privatisation is a parliamentary obligation in order to ensure that matters considered to be of national interest are properly protected -- but equally to ensure that *only* these matters are made subject to state control, for otherwise the company will be unable to realise the full benefits of being in the private sector.

Here too it must be emphasised that these benefits will not be realised unless ownership does actually pass from the public to the private sector. Some countries have thought they could obtain the benefits of privatisation by just selling a minority share of a state owned industry with the government retaining the majority holding. Such a sale entirely negates the true purpose of privatisation and so will not bring either the improvements in performance or the change in attitudes that are needed. Also, selling only a minority share confirms the prejudices of critics who say privatisation is merely a means of raising money for the exchequer.

7.

Securing the customer's interest

The customer's interest, as opposed to the *national* interest, is protected after privatisation by the operation of the free market. The ideal is always to privatise an industry or company into the competitive marketplace because genuine competition is always the best way to keep prices down and levels of quality and service up. The government's job is to make and enforce the rules that keep the market open and the competition real.

However it is not always possible to privatise state-owned monopolies into genuinely competitive markets. In Britain where we have had to privatise in the short term into a monopoly or semi-monopoly situation we are protecting the consumers' interests through the use of licences supervised by regulatory agencies.

Four main utilities have so far been privatised, to operate in this way with government-appointed but independent regulators; telecommunications, gas, water, and electricity. In addition, the British Airports Authority has been privatised to operate under a licence supervised by the CAA.

Concerns about possible abuse of monopoly power have particular regard to pricing, levels and quality of service, and the provision of uneconomic but socially necessary facilities; and so it is on these points that the licences and the work of the regulators focus.

With *pricing* there is a formula for each industry that stands as proxy for what real competition would do: it ensures consumers are not exploited, and it forces the company to use its resources as efficiently as possible. The formulas require the companies to base their prices on the RPI (Retail Price Index) plus or minus a percentage based on a collection of agreed factors such as the need for capital investment, fixed maintenance costs, service quality, and the provision of socially necessary facilities. The percentages and the agreed factors are periodically reviewed.

With *service levels and quality* the licences set clear performance targets which must be met. They also include specific requirements to maintain facilities that may be uneconomic but which are deemed socially necessary. British Telecom, for example, is required by its licence to provide the 999 emergency service and to maintain public call boxes even in uneconomic rural areas.

The controversy surrounding the rôle and practice of the regulatory agencies is most interesting to note. Not only are the battles fierce -- which is to be expected and indeed welcomed in a situation which is standing proxy for a genuine free market -- but they also show how the political debate has moved from a question of whether the major utilities should be privatised, to how effectively they can be made to conform to the licence requirements. Political opposition in Britain has stopped talking about re-nationalisation and now concentrates all its arguments on regulation.

There was much cynicism in the beginning about how effective the regulators could be against the might of the giant utilities, and talk was rife about *regulator capture* by the industries. This has not happened, and an interesting insight into one of the reasons why not can be seen in an article in the *Financial Times* of 4 April this year. Writing about the Director of Ofgas, regulator of the gas industry, the paper commented that people had expected him to treat it as a part-time job:-

> So it might have proved, except that British Gas decided on his first visit to its headquarters to teach [the Director] a lesson. When he enquired how such a fine building was financed, he was told to mind his own business. And he did. He bombarded the corporation with requests, and then demands for information, and then threats. He proved unexpectedly successful at PR, largely by telling the media most of what he was up to, US style. By threats of the High Court, a referral to the Monopolies and Mergers Commission and subtler hints of public interest and political pressures, he has carried through a succession of campaigns...

Licences and regulatory agencies are admttedly not the ideal way to protect the customer's interest and force companies to use resources efficiently. The ideal way is for companies to be faced with the permanent challenge of a competitive market. However when this is not immediately possible, the licences and agencies can work well.

8.

Persuading the doubters

Governments planning privatisations should accept that the policy is unlikely to be popular at first. This was certainly true in Britain in the early 1980s. At that time there was a widespread lack of knowledge in Britain about how capital markets worked and so about what *privatisation* actually meant. All the concerns cited earlier about national and consumer interests were covered at length in the media. These concerns had been intensified by two early, extremely controversial privatisations: Britoil, which was seen as a failure because it was *under*sold, and Amersham, which was seen as a scandal because it was *over*sold. The Britoil offering had been hit by the collapse in oil prices, and Amersham (which, having no market equivalent, was uniquely difficult to price), had been attractive beyond expectation. Both turned out to be very successful companies, but at the time the sales were bitterly attacked. The attacks were able to cast a shadow over the idea of privatisation partly because of public ignorance about the programme, but also because they served the purposes of certain vested interests and exploited the inertia that always resists change in the status quo.

Privatising governments can expect opposition from politicians (of their own party as well as from the official opposition), hostility from parts of the industries to be privatised, resistance from the financial community and bewilderment in the public at large.

All this can be overcome -- most effectively by having a very big, very successful and very visible privatisation, as with the sale of British Telecom in 1984, which at the time was the largest public flotation the world had seen.

Because of that sale and the many subsequent ones around the world the climate for privatisation now is quite different than it was in the early '80s, but it is worth looking at the pioneering BT sale since other countries may find themselves facing similar struggles.

Back in 1983 the Conservative Government in Britain was coping with many formidable political problems -- high unemployment and the aftermath of recession among them. Many of my Ministerial colleagues as well as a number of Conservative Members of Parliament thought a policy as controversial as privatisation should be deferred. What was the purpose, they asked, of stirring up yet another hornets' nest? The purpose, of course, was dramatically to improve the British economy and so contribute to the solving of the other problems. And that is indeed what happened. At the time, however, privatisation was unproven and it was necessary to fight in order to win the intellectual argument.

This we did through speeches, meetings, seminars and briefings with politicians, financiers, businessmen and journalists, all presenting the intellectual case for privatisation and the benefits it would bring to the industries involved and to the country as a whole. It was particularly important to allay the fears of the employees in the industries: fears often instigated and exploited by political opponents of privatisation.

The financial community offered some of the stiffest resistance: it doubted the capacity of the capital markets to absorb such huge issues and was not keen to expand that capacity by extending share ownership to the ordinary public. I remember one particularly acrimonious meeting about how the way to sell the enormous number of BT shares, during which I had been extolling the virtues of wider share ownership. One senior City figure -- in fact the head of a major brokerage house -- suddenly realised what I meant. *But John,* he said in a shocked voice, *we don't want all those kind of people owning shares, do we?*

Many politicians and financiers seriously doubted whether 'ordinary people' would ever be able to understand equity share ownership or whether (and this, remarkably, is an argument still heard) it is 'right' to allow them to take risks with their money.

Misguided and patronising attitudes like these are rarely influenced by verbal arguments. But the actual British Telecom sale proved to be a wonderful persuader. Before BT the world's biggest equity sale had been a secondary offering of an already existing company -- AT&T -- which was only just over a billion dollars. BT was to be over four billion pounds. Conventional wisdom was that it simply couldn't be sold.

But it was. *And not just sold -- it was nine times over subscribed.* More than two million people wanted to buy shares in British Telecom, demonstrating in the clearest possible way how alert people are to the opportunities a capital market provides and to what equity ownership is -- and how they have an appetite for both. Perhaps even more significant, over 90 per cent of BT employees took shares in what is now truly *their* company. Since the watershed BT sale, every British privatisation issue has been oversubscribed.

Many factors, of course, have played a part in this, and this short pamphlet necessarily over-simplifies what is a complicated and far-ranging process. For example, governments wanting to succeed with privatisation programmes must look hard at their tax regimes to ensure they offer encouragement, not impediments, to investment.

They should also look hard at the attitudes and assumptions inherent in their educational system. Until quite recently the educational establishment in Britain had a clear prejudice against capitalism which unquestionably had an effect on attitudes to privatisation.

Basic information on the free market economy was simply not taught, and worse, a feeling was conveyed that there was something *not quite nice* about the entrepreneurial spirit. The privatisation programme has both contributed to and benefited from a welcome change in this attitude.

It is true that for privatisation to be successful in countries with socialist traditions it has to be part of what is no less than a cultural revolution. The good news is that privatisation itself can be one of the most effective agents of such a revolution.

9.

The sale

One of many satisfying things about privatisation is the way the process itself has illustrated and validated the principles on which it is based. That is to say, market forces have had a salutary effect on the price of offerings, competition has markedly improved performance, and the need to reach new markets has prompted innovative and effective selling techniques.

Privatisation is an evolving process and in many ways is still in its pioneering stages. Each new issue around the world contributes something to the store of knowledge on which all countries can draw. But Britain was the first, and in many ways the British experience has set a pattern for others to follow.

Price, of course, is the pivot around which all sales -- whether of state owned industries or anything else -- revolve. The British experience on this suggests that any discussion of price should start with a warning to potential privatisers that the critics will always say you got it wrong. If your issue is oversubscribed they will say it was priced too low; if it is undersubscribed they will say it was priced too high. Whatever the price they will refuse to accept that privatisation has any purpose other than filling the Treasury coffers.

The best advice is to ignore the critics, and to draw on lessons learned through over ten years of actual experience. In Britain we have already wrestled with the problems of how to put a commercial value on an entity that never existed in the commercial world. We have also often had to try and uncover and illuminate value that may have been concealed by inefficient management -- or by political interference in management.

In the initial stages of doing this we felt very much at the mercy of professional bankers and brokers. Inevitably we wondered if we were getting the best possible service, and so turned to the traditional mechanism for improving performance: competition.

The *beauty contests* as they have come to be known, between bankers and brokers competing for government privatisation business, were deeply resented at first. This is not surprising -- most businesses would prefer to get contracts without having to compete. However the proof of the method is that the cost to the British government of financial services on privatisations has gone a lot down in the years since competition was introduced. It can also be convincingly argued that the skill with which the sales have been handled has gone up.

What kind of sale it is to be has also been an important factor affecting the price. A fixed price sale has the advantage of being simple and straightforward, but is often seen as unsophisticated and also dangerously vulnerable to outside events (Britoil was the classic example). Tender offers are usually preferred by financial professionals, but the British Government's view has been that tenders are likely to be a deterrent to small investors.

In order to try and gain the best of both of these kinds of sale we devised the fixed price/tender mix in which small investors subscribe for a fixed price and institutions submit tenders. Such mixed sales have been very successful.

Demand is, of course, a crucial factor in determining price, and a judgement on the likely demand for an offering is critical in deciding what price to put on the shares. This judgement depends in turn on attitudes towards share ownership and how much one believes demand can be stimulated.

It is at precisely this point in the British privatisation experience -- the question of demand -- that a practical need and a political objective met and were married to achieve a remarkable result.

The practical need was to sell the massive, new equity of British Telecom, more than had ever been sold at once before, or had ever been thought possible to sell. The political objective was radically to extend the market for equity ownership to people who had never bought or even thought of owning shares before.

One has to record that, however convenient, the consummation of this match did not take place without difficulties. The practical need was not in doubt -- we did have to sell a massive offering. But the consensus of all professional financial opinion was that it simply could not be done. I was told repeatedly that the capacity of the entire market at that time for all new equities was only £2 billion -- and here we were proposing to float £4 billion worth of BT shares. The solution -- hugely to extend the market and bring in masses of new buyers -- met every kind of resistance. There was the sort referred to earlier, the senior broker who was shocked at the idea of *those* people owning shares. There was also resistance from BT, which was not keen to service and deal with a great mass of small shareholders. There was resistance from the Treasury who thought it would cost too much to expand the market in such a dramatic way.

Even when it was grudgingly admitted that we would have to open up a new market there were bitter battles over how best to do it. One of the most bitter was over the 'small shareholders' bonus' which was proposed as an inducement to small investors. This offered a bonus of more shares -- 10 per cent of the number originally bought -- to a carefully defined category of small shareholders who kept their original shares for three years.

The idea was greeted with scorn. If the lure of share ownership was not sufficient to induce purchase in the first place why would the prospect of more shares in three years have any effect? The deriders favoured instead offering vouchers to share buyers to reduce their telephone bills. But vouchers, while obviously effective as a straight forward sales promotion technique, miss the essential point of the bonus, which is to encourage long term share holding. Studies of share holders' behaviour have shown that when new owners hold their shares for a reasonable period they *get the habit* of investment. They begin to take a real interest in the performance of *their* company and in the possibility of owning shares in other companies. From the companies' standpoint the small interested shareholders who keep their shares for some years constitute a new kind of investor, watching the company's performance with new eyes. They tend to have quite a different privatisation had its prospectus, but a formal prospectus can be a daunting document for novice investors. So we created the 'Pathfinder Prospectus' and the 'Mini Prospectus' which present the key facts for potential investors in a way accessible to non professionals. Most revolutionary of all, we instigated mass advertising on television, radio, billboards and throughout the print media, to bring the privatisation issues to the attention of the widest possible public. There can be hardly an adult who was alive in Britain in the 1980s who did not hear of 'Sid' in the British Gas flotation. The 'Sid' campaign and the others for privatisation issues (which were themselves the outcome of intense competitions between advertising agencies) were viewed with withering contempt by Britain's intelligentsia, probably again on the basis that 'those kind of people' had no business owning shares. Their contempt had no discernible effect. People of all kinds bought shares in British Gas, British Telecom, British Airways, the Water Industry . . . and in all the thirty major companies that have so far been privatised in Britain to date. Fully 60 per cent of the state sector has been transferred to the private sector together with more than 900,000 jobs. And above all, the number of individuals in Britain holding shares directly has gone from barely 7 per cent of the population to 25 per cent.

About eleven million people in Britain now own shares directly (i.e. not through a pension fund or unit or investment trust). This is very much to be welcomed, but it could and should be better. It is disappointing that the City is still not yet properly alive to the opportunities presented by the Government's policy of extending share ownership. Professional financiers still seem to regard unit trusts and investment trusts as the only proper vehicles through which individuals should hold shares, and the actual business of making and trading personal investments remains unnecessarily difficult. This is why the Government is promoting the chain of high street 'share shops' as part of the sale of the remaining state shares in BT. It is yet another demonstration of the Government's continuing commitment to give a chance to everyone who wishes to participate in the free capital markets.

This commitment is part of the overall political policy of the British Government to increase private ownership in every sphere.

However, politics apart, the policy has had the effect of increasing the capacity of the equity market beyond even the optimists' expectations. To repeat, in 1984 financial opinion said the total capacity of the market for new equity was £2 billion. In the single fiscal year 1988-89 privatisation issues raised £7 billion. Without a determined policy of widening the market for shares the success of large scale privatisations has to be in doubt.

Conclusion

The great wave of reform that has swept the world in recent years offers the best hope this century for millions of people to escape from tyranny into democracy and freedom.

But is that hope is to become reality much hard practical work is needed to re-establish, and in some cases build, the institutions that are necessary to a free society. Chief among these are the free market and individual ownership. Both are inseparable from liberty and from the improving living standards which democracy requires to thrive.

A blueprint does not yet exist for transforming a command economy into a free one, but one mechanism at least has been devised and shown to work: privatisation.

It is a tool whose utility is not in doubt. In Britain it helped rescue an economy heading for disaster and so made more secure the world's oldest parliamentary democracy. At present in countries round the world it is the most effective instrument being used to cut back the powers of overbearing governments. I believe it is in the interests of freedom, democracy and prosperity that it be even more widely used, and hope that the principles, policies and procedures pioneered in Britain will help to make that happen.