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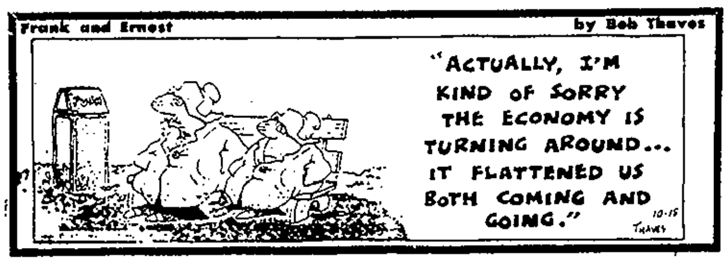

PRIVATISATION: A RE-ASSESSMENT

R.G. Walker

The idea of 'privatising' government trading enterprises ('GTEs') or other agencies has gained momentum and been popularised by a variety of interest groups, and supported by politicians across a wide range of the political spectrum. Yet, to date, there has been little detailed analysis of the *financial* implications to vendor governments (and, ultimately, the real owners, the public) of privatisation.

This paper seeks to contribute to a more informed debate by examining the financial implications of privatisation to vendor governments. It is suggested that privatisation may involve a substantial financial loss to the community. This is because the present value of the sale proceeds from GTEs, plus the present value of cash flows from post-privatisation taxes and charges, will generally be substantially less than the value of the cash flows which might be derived by government from retaining those organisations.

It is recognised that financial factors are only a sub-set of the factors which are relevant to decisions about selling or retaining public sector enterprises - just as initial government involvement in particular activities and enterprises would have been based on factors other than the evaluation of costs and benefits in purely financial terms. The paper is, in effect, an 'economic rationalist' analysis of financial issues relevant to the privatisation decision.

In order to focus on the fundamental differences in the circumstances of public sector and private sector enterprises, the discussion proceeds by analysing a series of scenarios in which a hypothetical GTE will generate a known stream of future cash flows. This enables the 'value' of a GTE to a private sector purchaser to be examined under a range of assumptions.

Reference to a hypothetical GTE also avoids the necessity to make judgments about such matters as the current financial position of a specific agency, the validity of past reports on its profitability, the extent of any past cross-subsidisation, the prospects of the particular industry in which that GTE operates, and its need for additional investment.

Claims Regarding Financial Benefits Of Privatisation

Arguments commonly advanced in favour of the sale of GTEs (or 'units' of government agencies) often include one or other of the following claims:

- **Reinvestment in alternative ventures will provide a better return than retention of an existing enterprise:** It may be claimed that public sector resources can be used as 'seed money' to initiate projects which might not otherwise attract private sector venture capital. Once established (the argument goes) these ventures could attract private sector investors, thus enabling resources to be reallocated for other purposes (see, eg, Independent Commission to Review State Finances [WA], Vol 2, p.44).

  There is certainly evidence that government initiatives have established new, and subsequently profitable businesses. Some of those enterprises would not have been established so readily or so cheaply without the government's power to acquire land or easements, or its power to establish barriers to entry to certain industries.

  However, it does not follow that the optimal way for a government to finance new ventures is necessarily from the privatisation of existing profitable businesses. At some point, the sale price of an existing business might be so low as to make the switching strategy unattractive. In some cases it may be more attractive to retain existing enterprises, and to use the cash flows generated by those businesses to service and repay any borrowings required to fund new ventures.

- **The proceeds of privatisation can be used to reduce the [reported] budget deficit:** Arguably, this is the most commonly-advanced argument for privatisation. To evaluate this argument, it is important to understand what a 'deficit' budget result actually represents.

  A budget deficit only reflects the results of a sub-set of public sector activities ('general government' or the 'budget sector'). Those financial results are calculated on a cash basis - as opposed to the 'accrual' basis commonly used by private sector firms. On an accrual basis, operating results may be better or worse than the outcomes suggested by cash-based results. One reason for this is that the cash-based results combine the impact of transactions of a 'recurrent' and 'capital' nature. While a government may have recorded a substantial cash deficit, it may have done so because it has invested heavily in infrastructure assets which will produce positive cash flows (or other benefits) in subsequent years.

  In the private sector, a company's cash flow statement may show a substantial deficiency from operating and investing activities, yet still record a profit; shareholders and creditors will evaluate that company's performance in light of beliefs about future performance. Indeed, it is well recognised that corporations may make massive investments in particular projects, leading to short-run cash shortfalls, with the aim of generating positive cash flows in later years. Some corporations experience clear-cut cycles of negative and positive cash flows as they enter new projects and then later enjoy the fruits of those investments. Security analysts are accustomed to interpreting the financial performance of private sector corporations by examining and relating a series of financial indicators.

  In contrast. many published analyses of the financial performance of governments are relatively unsophisticated, and tend to focus on a limited number of financial indicators (such as, 'the deficit', or 'the size of government debt'). Privatisation of government businesses may lead to a one-off cash injection which will improve budget results in the year of receipt. However (as demonstrated below) such transactions will not necessarily strengthen a government's financial circumstances.

- **Using the proceeds of sale of a government owned enterprise to reduce government 'debt':** This idea has been frequently advanced by Commonwealth and State politicians - and has been a common theme in reviews of state finances undertaken by independent 'commissions of audit', appointed by incoming State governments.

  Since 1988 there have been a series of such reviews in Australia. All advocated the privatisation of at least some activities, though without exploring the possibility that retention might produce better financial returns than sale (see NSW Commission of Audit, **Focus on Reform**, pp.109-13; Independent Commission to Review Tasmania's Public Sector Finances, T*asmania in the Nineties*, pp.205-6; SA Commission of Audit, *Charting the Way Forward*, PP. 340-350; *Report of the Independent Commission to Review State Finances* [WA], Vol 2, p.43).

  One notable exception was the Victorian Commission of Audit, which advocated sale of 'non-core activities', but also noted that privatisation of the State's major GTEs could have 'a negative impact on the budget position':

  > It is possible that privatising the State's major GBEs would have a negative impact on the budget position - that is, that the loss of dividends, tax-equivalent payments and other contributions would outweigh the savings in lower interest payments made possible by applying the sale proceeds to debt retirement (Victorian Commission of Audit, Vol. 1, p.ix).

The fact is that most (if not all) privatisation decisions have been undertaken in Australia without any detailed disclosure of the economic rationale for the sale.

Analysis Of Cash Flows

Occasionally one encounters suggestions that the reported profits of GTEs provide a good indicator of whether they are efficient or inefficient and, accordingly, whether it makes sense for those enterprises to be privatised. Two of Australia's economic advisory bodies (EPAC; the Industry Commission) have relied on reported profit data as an indicator of GTE commercial success or failure (Walker, 1993b). Those advisory bodies overlooked the fact that reported profits of government activities may be seriously affected by choices of accounting techniques and financing arrangements. Moreover, public sector organisations are not immune from involvement in financial transactions which may (as required) either disguise underlying profitability or enhance reported rates of return.

Accordingly, a more relevant basis for evaluating the financial implications of privatisation of GTEs is provided by a careful analysis of the cash flows likely to be received by a vendor-government if a particular GTE was retained, or sold.

(a) Cash flows from retention: As 'owner', a government may enjoy the benefit of cash flows from a government enterprise in several forms: dividends, interest revenues, tax equivalents, guarantee fees and other charges.

In some situations a GTE may have built-up excessive holdings of cash or other assets (particularly in light of the existence of any government guarantees for borrowings, which reduce the need to retain a 'cushion' of cash reserves in case of downturn or misadventure).

Conversely, a government-owner may be obliged to make contributions to an enterprise to enable the latter to undertake major capital works, or to initiate new ventures - just as listed corporations in the private sector resolve to make rights issues in order to raise additional equity capital.

Dividend distributions by a GTE will generally be related to enterprise profitability - though this is not necessarily the case. In NSW, for example, the government has demanded and received a series of 'special dividends' from GTEs (notably the Sydney County Council, Prospect

Electricity, and the Sydney Water Board), and those dividends substantially exceeded the current year's profits of those agencies.

The following diagram illustrates the sources of cash flows arising from either retention or sale.

Cash Flows from Retention or Sale

I. Retention:

Government ← Government Owned Enterprise

- Dividends
- Interest on loans
- 'Tax equivalents'
- Government guarantee fees
- Other fees or charges

II. Sale:

Government ← Purchaser

Proceeds of sale

← Formerly Government Owned Enterprise

- Taxes on post-sale income
- Other taxes (eg. sales tax)
- Other charges

A government may also receive **interest** on loans to GTEs. Some of these loans may reflect decisions to describe a government's pre-existing investment in a GTE as part 'equity', part 'debt'. This practice reduces the reported profits of those agencies by the amount of interest charged on 'debt'. This practice may be attractive for governments which wish to avoid suggesting that some GTEs are excessively profitable and are exploiting monopoly power.

In these situations, the choice of capital structure (ie the relative percentage of debt and equity) would not affect the aggregate returns to

the government, as owner/lender. The same would not be true in the private sector, where interest is a tax deduction. For private sector firms, the choice of equity structure would have real effects on tax payments and, hence, on cash flows to the owner/lender. Obviously the higher the level of interest-bearing loans from the government, the less the reported profits of a GTE.

For the purpose of analysing the cash flows generated by a GTE to the government, it is appropriate to treat cash flows in the form of dividends and cash flows in the form of interest payments on the same basis.

Similarly, it is appropriate to include cash flows described as 'tax equivalents', guarantee fees, or capital charges. Even though government enterprises may be exempt from Commonwealth income taxes, some States have established a regime whereby government enterprises are required to pay the equivalent of taxes to the consolidated fund. The claimed rationale for levying these notional taxes is to place GTEs on the same footing as private sector enterprises, and enable more direct comparisons to be made of the financial performance of enterprises from either sector.

Likewise, arguments about the supposed need for a level playing field have provided the rationale for governments to levy a 'guarantee charge' on enterprises which have borrowed with the benefit of government guarantees. The guarantee charge may be pitched at a rate which brings the financing costs of a government owned enterprise into line with the rates of interest payable by comparable private sector firms. Whatever the rationale, these charges provide additional cash flows to the owner-government while reducing the reported profits of a government owned enterprise.

Overall, a government may be enjoying a stream of cash flows from its ownership of a GTE. These cash flows would cease if an enterprise was sold.

(b) Cash flows from sale: The amount a prospective purchaser would be prepared to pay to acquire a GTE will depend, to a large extent, on the purchaser's expectations about the cash flows which can be generated from that enterprise in the future.

Managers of a private sector corporation contemplating the purchase of a GTE may believe that they can earn financial returns superior to those earned under public ownership. They may plan to apply improved technologies, or to secure synergies from linking their existing activities with those conducted by the GTE. They may believe they can introduce 'efficiencies' through reduced staffing, less expensive employment arrangements (notably, defined-benefit superannuation schemes), and the avoidance of unprofitable activities which governments deem 'community service obligations'.

Undoubtedly there will always be scope for any organisation to introduce marginal 'efficiencies'. Further, it may be possible for private sector managers to increase prices more than might be feasible under public ownership (where governments are subject to targeted pressure from constituents). Indeed, some governments may view privatisation as a way of avoiding the opprobrium associated with increasing the prices of certain services.

The extent to which a change of management after privatisation might lead to 'efficiencies' would depend both on how effectively the GTE has been managed in the past, and the nature of its operations (eg there may be greater opportunity to introduce 'efficiencies' in labour intensive activities than in capital intensive activities which utilise a small workforce).

However, there are some other fundamental factors affecting the price which might be offered by a private sector entity to acquire a GTE. A private sector buyer will not bid more than the 'value' it ascribes to an enterprise, where 'value' represents the present value of the cash flows expected to be derived from that investment.

The circumstances of governments and private sector purchasers are different:

- Private sector purchasers of government businesses face ***a higher cost of capital*** since they must provide an equity return to their shareholders while also paying higher rates of interest on borrowings than are faced by sovereign governments.

- Private sector purchasers ***are liable to pay company tax (and other taxes and charges)*** whereas Commonwealth and State statutory authorities are exempt from company tax, and may be exempt from other State or Commonwealth charges, and local government rates.

Because of these differences alone, the present value of the cash flows to be derived from a GTE is likely to be significantly less to a private sector purchaser than it is to the government-vendor. That means that the maximum price a private sector purchaser can afford to pay to buy a GTE will be less than the value of that enterprise to the vendor-government (and hence to the community which that government represents).

The extent of these differences in present values will vary between bidders because of differences in their credit ratings (and hence interest costs), differences in the availability of carry-forward tax losses, and so forth. The extent of the 'gap' between value to a purchaser and value to a government vendor may be affected by the vendor providing tax concessions, or by the buyer adopting tax minimisation strategies, as well as prospective 'efficiencies'. Buyers may also assess the extent to which they may be able to increase prices once a sale has been consummated; they may also make allowance for the likely cost of dealing with government agencies established to regulate prices, trade practices, or environmental issues.

The price paid by a purchaser will exceed the proceeds received by the government because of transaction costs. The benefit from these transaction costs (such as the preparation of prospectus, and the marketing of a float) will go to intermediaries: lawyers, accountants, advertising and marketing consultants, underwriters and brokers.

There are likely to be some economies of scale in relation to transactions costs: the larger the transaction, the less the level of transactions costs as a percentage terms of gross proceeds (Woo & Lange, 1992). UK experience indicates that the expenses of privatisation have ranged from 2.8% to 11.2% of gross proceeds (Vickers & Yarrow, 1988, pp. 174, 181; National Audit Office, 1992, p. 23; Walker & Howard, 1992, p.9). Experience with some major Australian privatisations has been mixed.

The expenses of the 1991 sale of around 30% of the Commonwealth Bank appears to have constituted 2.9% of the gross proceeds; however, given that much of the work was undertaken in-house, this estimate may be a little conservative. On the other hand, the privatisation of the NSW Government Insurance Office (GIO) cost over $71 million, or 5.94% of the proceeds (Walker & Howard, 1992, pp.8-9).

(c) Cash flows after sale: A national government which privatises a GTE can normally expect to receive cash flows after the sale from taxes levied on the profits of the newly-privatised enterprise. GTEs may also be exempt from sales tax, but may be liable to pay sales taxes after a change of ownership.

State governments which sell off their business activities will not receive taxes on the profits of those newly-privatised entities; any cash flows from company taxes will go to the Commonwealth. Hence the Commonwealth has provided Victoria and NSW with compensation following the sale of the State Bank of Victoria, and the Government Insurance Office, respectively. In 1991 the Commonwealth indicated that compensation was to be based on the expected increase in Commonwealth tax revenues following privatisation. However in 1993 the Commonwealth announced that these compensation payments must be viewed as 'one-off' since, henceforth, the Commonwealth would only provide compensation for one privatisation of a bank or insurance company per State, while promising to examine other proposed privatisations on a case-by-case basis.

On the other hand, State governments could receive cash flows from State payroll taxes or land taxes following privatisation. Correspondingly, the newly-privatised entity will face increases in expenses from these items, and, in addition, will lose its prior exemption from local government rates.

However private sector firms can be expected to undertake tax-minimisation strategies. Indeed, the more a purchaser can minimise the amount of tax payable on future revenue streams, the higher the price it will be prepared to pay for an acquisition. Conversely, if the vendor-government allows purchasers to select the type of vehicle to be used in the acquisition (rather than bid for shares in a previously-established corporation), or to exercise discretion over the way in which the assets acquired are valued for tax purposes, the vendor may be effectively trading off a higher 'headline' sales price against lower future cash flows from company taxes.

'Modelling' the Privatisation Decision

Assumptions: The operations conducted by a hypothetical GTE are capital intensive operations. The GTE has recently invested in infrastructure which is not capable of alternative uses; moreover, the technology is extremely durable, so that the GTE's assets do not physically 'depreciate'. The GTE has no borrowings. Its revenues are received entirely in cash and it generates a profit/operating cash flow of $100 million per annum. The GTE is expected to continue to generate that profit, without further investment or the need for additional staffing, into the foreseeable future. Profits are distributed in their entirety as dividends.

Let us also assume that the long term government bond rate for the owner-government is 8% pa. Interest rates required by investors in debt securities issued by private sector corporations will be higher. It is assumed that corporate borrowings can be undertaken at 9.5% pa.

Equity investors face higher risks than lenders, and demand a higher return than that payable on debt securities. It is assumed that contributors of equity capital seek a rate of return of 14% pa (before tax).

Finally, it is assumed that company tax rates are 33c in the dollar, and that transaction costs approximate 4% of the gross sale price on privatisation.

Retention value: The retention value of the GTE to the government is the amount which would otherwise have to be invested at the prevailing cost of capital in order to generate a return of $100 million per annum.

Given a marginal government borrowing rate of 8% per annum, retention value would be $1,250 million[1].

Proceeds of sale: The value of the same business to a prospective private sector purchaser would be much less than retention value to the government, as (a) the cost of capital of a private firm would be far higher than the rate available to a government, and (b) the private sector purchaser would be subject to a range of taxes and charges (to which the public-sector vendor is exempt).

In practice, prospective purchasers may under-bid, seeking a bargain purchase. Moreover, whatever the bid price, sale proceeds to the government will be reduced by transaction costs.

Scenario 1: Purchase financed by equity

Suppose that a potential purchaser could finance an acquisition without borrowing. As the GTE generates $100 million per annum, and the purchaser seeks a pre-tax return to equity investors of 14% per annum, the maximum price that the purchaser would pay would represent the present value of projected pre-tax cash flows discounted at 14% pa: $714 million. With transaction costs of 4%, the net proceeds of sale would be $686 million. This would represent only 55% of the GTE's retention value.

1 Some responses to an earlier draft of this paper were that the appropriate discount rate to use for calculating the retention value 'should be' the current marginal cost of capital rate of the taxpayers. It was contended that use of the the government's borrowing rate would encourage governments to invest in 'uneconomic' projects. This contention seems to reflect an extreme ideological view about what 'should be' the role of the public sector, rather than the way markets actually price government securities. Investment in a government security is viewed as 'low risk' because responsibility for repayment is effectively insured by the entire community. That markets assess government securities as low risk is reflected in the fact that in mid 1994 the difference in yields between the highest and lowest rated Australian government bonds (the Commonwealth and Tasmania, respectively) was only 40 basis points.

Scenario 2: Purchaser financed by debt and equity

In practice, a purchaser may take advantage of debt finance. Given that interest paid on borrowings is less than the returns demanded by contributors of equity capital, and that interest payments are tax-deductible, a prospective purchaser can expect to secure a higher rate of return for shareholders by borrowing.

The higher the level of borrowings, the higher the risks faced by equity investors (and hence, in turn, the higher return demanded by those investors). However, the hypothetical GTE has regular and positive cash flows, and as such is 'low risk'. It seems reasonable to assume that in these circumstances a prospective purchaser would be prepared to finance the purchase with 50% - 60% debt finance, perhaps higher. To illustrate the impact of using debt finance, it is (initially) assumed that a purchaser proposes to raise $500 million from borrowings, and the balance through equity.

The purchaser would assess the prospective cash flows to be derived from the enterprise, as follows:

	Value ($)
Earnings before interest and taxes	100m pa
Less	
9.5% interest on $500 million borrowings	48 m pa
Earnings after interest	52m pa
Company tax on $52m at 33c in $	17m pa
Earnings after interest and taxes	35m pa
The maximum proceeds from sale of the GTE would be:	
Maximum purchase price	871m
Financed by borrowings	500m
Financed by equity	371m
Less	
Transaction costs	35m
Net proceeds to Government	836m

A comparison of Scenarios 1 and 2 shows that the net proceeds are a higher percentage of retention value (67%) where a purchaser utilises debt finance than where the purchaser relies wholly on equity finance (55%).

Both Scenarios 1 and 2 assumed that the rate of return demanded by equity investors is 14% pa. Table 1 shows the sensitivity of the financial returns from privatisation to both different levels of 'borrowings', and differences in the returns sought by equity holders.

Table 1: Maximum Proceeds as Percentage of Retention Value

Borrowings	$300m	$400m	$500m	$600m	$700m	$800m	$900m
Debt as % total investment	35-40	44-51	55-60	64-69	73-77	81-84	89-91
Return sought on equity							
16.00%	57%	60%	64%	67%	70%	73%	76%
15.00%	60%	62%	65%	68%	71%	74%	77%
14.00%	62%	65%	67%	70%	72%	75%	77%
13.00%	65%	67%	69%	71%	74%	76%	78%
12.00%	69%	70%	72%	74%	75%	77%	78%

The data in Table 1 suggest that the maximum proceeds from sale of a GTE may only be 57% - 78% of retention value, depending on the capital structure of the acquiring firm. In practice, the returns demanded by equity holders will not be independent of the gearing of the privatised enterprise: the higher the gearing (the proportion of debt relative to equity), the higher the risk and hence the higher the returns demanded by equity investors - and vice versa. Accordingly the relevant values are likely to be within the unshaded cells ie **the maximum proceeds from sale of a GTE may only be 65% - 77% of retention value**.

This means that **the initial loss to the government from privatisation is likely to be in the range of 23% - 35% of retention value**. Again, in practice, a purchaser may bid well below the 'maximum' bid price, so that the loss may be greater.

As already noted, part of this 'loss' may be recovered by post-privatisation tax revenues if the vendor is a Commonwealth government.

Scenario 3: Impact of post-privatisation taxes

As company profits are subject to tax, the cash flows to the Commonwealth government arising from privatisation of a GTE will comprise sale proceeds, and the stream of company taxes to be paid after privatisation.

Using the data in Scenario 2, and assuming there is no 'leakage' of tax revenues through use of tax-minimisation strategies, the maximum value of the tax stream to be derived under the foregoing assumptions would be:

Present value of revenue stream of $17.3m pa discounted at 8% pa	$216m

Hence the overall minimum residual loss from privatisation of a Commonwealth GTE would be:

Value to government from retention		$1,250m
Maximum sale proceeds		$836m
Maximum present value of tax stream	216m	1,052m
Minimum residual loss from privatisation		198m

Whereas the use of debt finance increases the maximum proceeds on sale, the overall net proceeds to government from sale proceeds and tax streams combined actually decline as borrowings increase. Table 2 illustrates this phenomenon.

The data in Table 2 suggest that the minimum net loss to the Commonwealth (after counting post-privatisation tax receipts) would be between 8% - 19% of retention value.

These examples do not exhaust the range of income-tax minimising strategies which might be adopted by a prospective purchaser, or strategies which might divert 'profits' earned in Australia to off-shore corporations. However only one will be examined in any detail: the use of off-shore financing arrangements.

This device substantially reduces the financial returns from privatisation to the Commonwealth. Table 3 illustrates the impact on returns to the Commonwealth of off-shore borrowings subject to withholding tax.

Table 2: Aggregate Proceeds and Tax as Percentage of Retention Value (Commonwealth Government)

Borrowings (9.5%)	$300m	$400m	$500m	$600m	$700m	$800m	$900m
Debt as % total investment	35-40	44-51	55-60	64-69	73-77	81-84	89-91
Return sought on equity							
16.00%	81%	81%	81%	81%	81%	81%	81%
15.00%	83%	83%	83%	82%	82%	82%	81%
14.00%	86%	85%	85%	84%	83%	83%	82%
13.00%	89%	88%	87%	86%	85%	84%	83%
12.00%	92%	91%	89%	88%	86%	85%	83%

However a rational purchaser will seek to minimise or defer payment of company taxes. For example, a purchaser may:

- revalue assets to 'current values', giving rise to higher tax-deductible depreciation charges, thus reducing payments of company tax;
- structure the acquisition to take advantage of any carry-forward tax losses;
- elect to use accelerated depreciation methods for tax purpose, which will defer the timing of cash payments and hence reduce their value to the government;
- finance the acquisition through borrowings from an off-shore associate. This would enable the purchasing entity to treat some of the cash flows earned from the newly-acquired business as tax-deductible interest payments to an off-shore associated company. As those payments would only be subject to 10% withholding tax, this arrangement would reduce the cash flow to the Commonwealth.

Table 3: Aggregate (After Tax) Loss as Percentage of Retention Value (Assuming use of Off-Shore Financing)

Borrowings	$300m	$400m	$500m	$600m	$700m	$800m	$900m
Debt as % total investment	35-40	44-51	55-60	64-69	73-77	81-84	89-91
Return sought on equity							
16.00%	20%	20%	20%	20%	20%	21%	21%
15.00%	17%	18%	18%	19%	19%	20%	20%
14.00%	15%	16%	16%	17%	18%	19%	20%
13.00%	12%	13%	14%	15%	17%	18%	19%
12.00%	8%	10%	12%	13%	15%	17%	18%

A State Government may be able to produce higher sale proceeds by assisting a purchaser to adopt tax minimisation strategies (eg through increased depreciation charges). In effect, a State Government can increase its sale proceeds at the expense of the Commonwealth.

Scenario 4: Effect of post-privatisation 'efficiencies' on government revenue streams

It is commonly suggested that privatisation could lead to greater efficiencies. This leads to the suggestion that governments could benefit from increases in profitability through increased taxes on the revenues of the privatised GTE.

There are usually pockets of inefficiency in every business; likewise it must be conceded that a change of management can often revitalise an organisation. The performance of both public sector organisations and private sector organisations can change (for better or for worse) with a change of management. However, there are grounds to be sceptical about suggestions that privatisation will produce such a quantum leap in efficiency that it will compensate government-vendors for the loss of value on sale through post-privatisation tax streams.

To illustrate, let us compare two GTEs. Both generate profits of $100 million per annum. However, one has a small workforce and a large investment in infrastructure assets; the other has only minor investment in equipment, and a large workforce:

	Scenario 5 Capital intensive Organisation	Scenario 6 Labour intensive Organisation
Earnings	$100m pa	$100m pa
After charging		
Wages & salaries	$3m	$90m
(average $30,000 pa)	(100 employees)	(3000 employees)
Net Assets	$1000m	$100m

Suppose that the prospective purchasers of these organisations believe that they can find ways of producing the same level and quality of goods or services as are presently being provided by those two organisations, with a reduction of the workforce of 20%. In other words, (assuming no change in demand for the goods or services provided by those entities) the purchasers estimate that the future sustainable earnings of the two organisations will be as follows:

	Capital intensive Organisation	Labour intensive Organisation
Earnings when govt. owned	$100m pa	$100m pa
Add		
Projected reduction in expenses	$0.6m pa	$18.0m pa
Projected earnings after privatisation (before interest and taxes)	**$100.6m pa**	**$118m pa**

However, even adopting such extreme assumptions about the possibility of cuts in operating expenses, the supposed 'efficiency gains' still do not eliminate the loss of value on privatisation for the capital intensive GTE.

To illustrate, the following example adopts the same underlying assumptions about interest rates, equity returns and tax rates as in earlier Scenarios (save that here the purchasers finance their acquisitions with 50% debt and 50% equity):

	Capital intensive organisation	Labour intensive organisation
Value to government:	$1,250m	$1,250m
Value to purchaser (Financed 50% debt, 50% equity)	$856m	$957m
Maximum proceeds from sale (after transaction costs)	$822m	$919m
Max. present value of tax stream	$247m	$290m
Total proceeds & tax	$1069m	$1254m
Loss (gain) to govt	**$188m**	**($4m)**

Here, the initial losses from privatisation are greater for the capital intensive than for the labour intensive enterprise. Again, for the capital intensive GTE, only part of these losses can be recouped from post-privatisation tax revenues, despite massive 'efficiency gains'.

On the other hand, the final outcome from privatisation of the hypothetical labour intensive GTE is in fact a surplus for the Commonwealth government, relative to retention value. Indeed, on the numbers presented here the the break-even point for the government from sale of the hypothetical labour intensive GTE would only occur when there was a profit improvement of around 16%. Many authors have claimed that privatisation can lead to 'efficiencies', there are few cases where gains of that scale have been achieved. One of the most comprehensive international studies of privatisation found that only 55% of privatised firms showed an improvement in operating performance, and that overall the mean change was only a 0.16% improvement in the reported rate of return on equity (Megginson, Nash and Van Randenborgh, 1994).

Moreover, attribution of those gains to privatisation is in itself contentious, as it assumes that any efficiency gains obtained by private sector managers could not have been secured if GTEs remained in public ownership. The evidence from some studies suggests otherwise (see Domberger & Piggott, 1986).

Conclusions and Policy Implications

The foregoing discussion and illustrations suggest that in most circumstances, it would not make good sense to privatise GTEs which are producing positive cash flows.

The major findings are:

(i) **The privatisation of government trading enterprises, and the application of the proceeds to debt reduction, does not necessarily confer financial benefits on the community.**

The attractiveness or otherwise of such transactions depends on the relative returns earned by the government from a GTE's dividend distributions, taxes and related charges, relative to the cash flows avoided by reducing interest commitments.

(ii) **Because a private sector purchaser faces a higher cost of capital than does a government, the proceeds from privatisation are likely to be substantially less than the 'value to the government' from retention of an enterprise.**

Using a range of representative assumptions about the 'gap' between interest rates payable by government and private sector borrowers, and the rates of return sought by private sector investors, the findings were that the maximum likely to be bid by a private sector purchaser would be in the range of 57% - 78% of the value of the retention value of government owned businesses.

The scale of the immediate losses incurred on privatisation will be related to, *inter alia*:

- interest rate differentials between a government and a private sector borrower;
- the capital structure adopted by the purchaser;
- the return demanded by equity investors (over and above that payable on debt finance);
- the level of transaction costs.

Moreover, bidders may seek to make bargain purchases, and they may make allowances for the anticipated costs of dealing with regulatory agencies.

A final qualification: it is not suggested that governments should never dispose of any business activity - nor is it suggested that governments should nationalise every business. Assumptions about the relative costs of public sector borrowings, private sector borrowings and the returns demanded by private sector investors in equities are fundamental to the foregoing analysis. The relative costs of finance might change if (for example) a government embarked on a major borrowing programme and was investing in high-risk ventures. However it is reiterated that the rates used in these illustrations presented above are similar to those selected by a number of consultants in reports advocating the privatisation of publicly-owned enterprises.

(iii) Post-privatisation tax collections may recover only part of the 'loss of value' arising from sale

Commonwealth company tax collections may constitute a material component of the set of cash flows derived by government after privatisation - but the present value of these cash flows will not outweigh the 'loss' incurred on sale. State governments may mitigate their losses through post-privatisation payroll taxes, land taxes and other charges, but only to a relatively minor extent.

Little weight should be given to suggestions that a privatised entity will generate higher profits through efficiencies, and hence will produce a higher revenue stream to the government. Many government owned enterprises are capital intensive, so that supposed private sector 'efficiencies' would only have a minor effect on post-privatisation profitability. Opportunities for improvements in profitability may be greater in labour intensive organisations, but such improvements would have to be substantial to compensate the vendor government for the loss on sale.

Moreover, it is only to be expected that private sector purchasers will adopt tax minimisation strategies - which in turn will reduce the post-privatisation revenue streams of the vendor.

(iv) Governments may increase the sale price on privatisation by initiatives which reduce post-privatisation cash flows.

The sale of a GTE may stimulate media attention and prompt criticism from parties who consider that the consideration in such transactions is inadequate.

Conversely, governments which otherwise would report a deficit on their budget results face incentives to maximise the sale proceeds on privatisation transactions. The greater the sale price, the greater the reduction in the reported deficit - and, correspondingly, the less the increase in government 'debt'. Although it might be argued that these indicators are less significant than others (eg the surplus or deficit for the 'whole of government', or trends in the quantum of aggregate 'liabilities', or trends in investment in infrastructure assets) the media and political commentators tend to focus on the traditional, cash-based budget results.

The desire to report improved budget results may encourage governments to introduce sale conditions which may lead to higher prices on sale - but lower cash flows later. Examples of such initiatives are easy to find. For example:

> The NSW Government's proposals to privatise the State Bank of NSW included the condition that existing borrowings by the SBNSW will continue to be subject to a government guarantee until maturity. Moreover, the NSW Government agreed to indemnify the purchaser against 90% of any further bad debts on the Bank's loan portfolio above a threshhold of $60 million (Premier of New South Wales, News Release 'NSW Government sells State Bank'. 29 September 1994).

> The Commonwealth's **One Nation** statement in 1992 announced the introduction of 'infrastructure bonds', interest on which will be non-assessable in the hands of the bondholder - an initiative which has been described as promising 'cost effective' funding for certain strictly-defined projects (land transport, ports and electricity generation) (Robinson, 1994).

> The Commonwealth's 1994 **Working Nation** statement moved to encourage more private sector investment in infrastructure by offering a tax rebate of 33 per cent as an alternative to non-assessable income to encourage taxpayers with marginal tax rates below 33 per cent to invest in infrastructure bonds. It also extended the eligibility for infrastructure bonds to aviation, electricity transmission and distribution, gas transmission facilities, water and sewerage treatment projects and other water infrastructure (**Working Nation**, p.44)

Some initiatives have taken the form of a *laissez faire* attitude towards the tax minimisation strategies likely to be adopted by a private sector purchaser of a GTE. For example, proposals for the sale of the Pipeline Authority did not constrain the purchaser from revaluing assets upwards, thus giving rise to increased depreciation charges and, hence, lower taxable profits after privatisation. Proposals for the sale of the Housing Loans Insurance Corporation permitted the purchaser to amend the HLIC's deferral of revenue recognition on single-premium mortgage insurance policies - thus avoiding tax exposure on that deferred income. All such initiatives reduce the cash flows to be derived by governments, post-privatisation.

The findings suggest that privatisation can have a serious impact on government finances. Hence it can be argued that governments should be more open about privatisation arrangements, to ensure that major financial transactions are subject to prior Parliamentary (and public) scrutiny.

Claims about the need to maintain 'commercial confidentiality' concerning proposed privatisations seem anomalous, when contrasted with the more demanding disclosures required of listed companies facing takeover bids or contemplating the sale of major undertakings.

Listed companies which propose to sell their major business undertaking must first seek ratification of the proposal by shareholders in general meeting (Australian Stock Exchange, Listing Rule 3S). Hence companies must provide shareholders with a notice which explains the rationale for any such proposal. Further, shareholders must be provided with reports from 'experts' when certain transactions are contemplated: takeover bids, or proposals to compulsorily acquire the interests of minority shareholders, or when directors propose to engage in major transactions with related parties. These 'experts' reports' must include a reasoned assessment of whether an offer is fair and reasonable (see Corporations Law, subsections 648(1) and 703(5); Australian Stock Exchange, Listing Rule 3J(3); NCSC Policy Release 140; ASC Policy Statement 75, 1993).

However, when governments signal their intention to 'privatise' particular agencies, equivalent information has not been made available to members of parliament, or to the community.

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TRANSNATIONAL CORPORATE PLANNING AND NATIONAL INDUSTRIAL PLANNING: THE CASE OF THE FORD MOTOR COMPANY IN AUSTRALIA[1]

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Ford Australia made two announcements on the 9th February 1994. One was for the closure of the Sydney Assembly Plant at Homebush in September 1994, and the end of production of the Ford Laser. The other was that the Ford Capri sports car would cease production in May 1994. This created much media interest for a couple of days, and then the issue disappeared. A few days earlier Mitsubishi confirmed plans to inject $500 million in the development and production of a new Magna model for 1996, with continued export to Europe and the U.S. of this vehicle in station wagon form. In contrast to Ford's announcements, Mitsubishi's plans attracted virtually no media interest.

The two items together encapsulate the dramatic structural changes currently going on in the Australian motor vehicle industry. In the mid-1980's Ford Australia was the undisputed leader in this industry. It had the largest market share and was the only one of the then five manufacturers consistently making profits. In February 1994, Ford Australia was the only manufacturer which had not made a long-term commitment concerning its future in Australia. Nissan abandoned local production in 1992. Toyota and Holden merged most of their

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