Special report

The ALP meets

IN SOME WAYS DAWN FRASER IS THE EPITOME OF THE disaffected Labor Party supporter. When voters in Balmain swung away from Labor at the NSW elections, she was the principal beneficiary. Unlike many of her state and federal counterparts, Fraser lived in her electorate. She didn't disguise her admiration for Neville Wran and Gough Whitlam, Labor leaders who weren't products of the 'machine' in the same way as Barrie Unsworth, and who promised liberal reforms. She aligned herself with 'battlers', the traditional Labor voters who felt living standards being squeezed.

Irrespective of the precise causes of Labor's defeat in NSW, the impression lingers on: the party is out of touch. Has the ALP swung away from its supporters, or has the political mood changed?

No need to privatise

Peter Botsman and Bill Mitchell argue for a shift in perspective on privatisation, and respond to Greg Crough's criticism (overleaf) of their recent report.

SINCE IT WAS RELEASED IN APRIL, the H V Evatt Research Centre's report, *The Capital Funding of Public Enterprises*, has received a great deal of media coverage. The first thousand copies of the report sold out within days. Its significant impact on the privatisation debate is reflected in comments — pro and con — by senior members of government and key public officials.

Yet, despite all this, and despite the fact that the research is thorough and persuasive, there are important issues raised in the report that are in danger of being ignored by government.

The Evatt report focuses on what has become the main debating point in recent months, the 'capital base problem' facing Commonwealth public enterprises. In lay terms, government investment in enterprises such as Australian Airlines, Qantas, Telecom, the Commonwealth Bank, OTC and Aussat is inadequate.

Capital shortages are not unique to public enterprises: any sustained business development depends on access to capital for investment in income-earning assets. But in the past the close relationship between public enterprises and government has actually hindered their ability to raise capital — regardless of the fact that each of the enterprises listed above would have been stronger and more self sufficient if it had access to secure, long-term capital.

Australian Airlines: first in the privatisation firing line

Partly this capital problem is a result of challenges to government activity and public enterprises around the world, which have discouraged both major political parties in Australia from guaranteeing the future capital needs of enterprises.

Despite these constraints, public enterprises have generally performed remarkably well. The Commonwealth Bank, a popular target for advocates of privatisation, is a good example. The bank performs an important social role — as a major lender for housing and to charities and public bodies. Because the bank's critics have concentrated on efficiency issues, the Evatt report focuses on the bank's commercial performance. A look at the annual reports of the four banks shows that the rate of return on shareholders' funds for the CBC in 1986 and 1987 was comparable to the private banks' rate. The CBC returned 14.9 per cent in 1987 and 13.6 per cent in 1986, the ANZ 13.5 per cent (1986) and 16.7 per cent (1987), the National 14.6 per cent (1986) and 18.2 per cent (1987), and Westpac 15.4 per cent (1986) and 18.2 per cent (1987).

Obviously it is wrong to argue that these returns are deficient by private sector standards. A major problem the CBC has faced in recent years has been high interest rates. Because the bank is heavily engaged in the retail end of the banking sector (as a major lender for housing, for example) a high percentage of its loan portfolio is subject to interest rate ceilings. That the bank was able to achieve comparable returns to other banks while facing this squeeze on its interest margins is strong evidence of its efficiency.

Within the budget process the federal government has the capacity to alleviate the immediate strains of the CBC's capital shortage. Even critics of the CBC, such as Boris Schedvin writing recently in the *Financial Review*, acknowledge that there are additional solutions to the bank's capital needs. Improved earnings are likely to result from declining interest rates and the strong growth in retail banking which the CBC dominates. The State Bank of NSW has recently shown the restructuring capabilities of a subordinated debt issue. Private firms often defer dividend payments if they can be better used to strengthen the company's long-term earning capacity; why should the federal government always demand a dividend from the CBC?

T*HE CAPITAL FUNDING OF PUBLIC Enterprises* was designed to confront these issues head-on by putting forward a series of viable solutions to the capital problem and providing essential information about the history and management of public enterprises. The report proposes a package of options which could be developed into long-term financial plans for each Commonwealth enterprise. These include making government loans to public enterprises with a flexible system of repayments, relaxing Loan Council controls on specific items (such as subordinated debt for the Commonwealth Bank), converting some Commonwealth loans to equity investment subject to guaranteed returns, establishing a holding authority to decide on finances for enterprises according to commercial criteria, selectively reducing dividend requirements, and revaluing the assets of public enterprises at current market values. None of these proposals would compromise the principles of responsible economic policy.

In some cases, a direct injection of funds from the budget may be necessary. Australian Airlines, for instance, has argued that it needs $240 million over the next three years to purchase aircraft and equipment. This is certainly a significant sum. But according to a caucus report prepared for the communications minister, Gareth Evans, it would 'allow increased dividends and there would be scope for the airline to seek out profitable new investment opportunities'. A conservative expectation would be that within five years Australian Airlines would have repaid that amount through dividend payments alone!

There are other reforms necessary to enable public enterprises to be fully competitive and self-financing. For instance:

- Public enterprises need long-term financial plans and a guarantee of more managerial autonomy.
- Government accounting procedures need to be brought into line with OECD guidelines. At present the federal government uses accounting conventions which obscure the distinction between government borrowing for consumption and for capital finance for public enterprises. There are significant economic and financial differences between these two categories of borrowing.
- Optimal structures for public enterprises need to be developed, if necessary through growth and amalgamations.

Equally, the social responsibilities of public enterprises need to be developed. Too often this objective is left out of assessments of enterprise performance. The Evatt report estimated that public enterprises contribute up to $5 billion in income transfers to low-income earners and through social services. Without public enterprises these services would have to be financed directly through the budget.

The Evatt report emphasises the fact that the unique character of public enterprises is that they perform key social *and* economic functions. In doing this, they often achieve better results than the market could or would. But the service role of public enterprises can undoubtedly be improved: public ownership is not a sufficient guarantee of social responsiveness. As Barry Hindess, professor of sociology at the Australia National University, argued recently: 'We have to redesign the agencies of public decision and develop other means by which public concerns and objectives may be established.'

IN THE LIGHT OF THESE ARGUMENTS, why does privatisation continue to attract support? There are two main reasons.

First, asset sales have political advantages. In the short term, they cause a fall in the public sector borrowing requirement (PSBR). But as a method of reducing government borrowings, asset sales are a double-edged sword. As a result of privatisation all the current social obligations of public enterprises would have to be provided for directly from the federal budget. The government would lose the advantage of a largely self-financing social services system.

Nor is the PSBR a satisfactory measure of the government's budget policy. As mentioned above, it makes no distinction between borrowing for consumption and borrowing for investment, two quite different forms of expenditure. It is being suggested that the government can expand its borrowing and spending on welfare and still achieve a fall in the PSBR by selling assets. The net result would be a loss of revenue-producing assets, which over the long term would dramatically reduce the government's fiscal flexibility and financial standing. We could expect the financial community to react in the same way as it would to a company which sold off its revenue sources and at the same time increased spending!

The second major reason why privatisation continues to be advocated rests on the view that the private sector is axiomatically more efficient than the public sector. On the basis of a range of international studies, detailed in the report, *The Capital Funding of Public Enterprises* argued that neither pro- nor anti-privatisers can claim a clear victory on this point.

The argument that public enterprise is less efficient is therefore tenuous. Even more important is the fact that in many areas, particularly where there are social as well as economic objectives to be achieved, public enterprises perform better than private. As in the case of Australian Airlines, it may be that restrictive trading agreements, financial strategies and growth restraint by government have affected the performance of the enterprise. But each of these factors can be dealt with without changing ownership.

It is difficult to avoid the conclusion that argument for privatisation on the grounds of efficiency comes down to a general ideological position rather than a convincing economic argument.

IN THIS EDITION OF AUSTRALIAN SOCIETY Greg Crough outlines some criticisms of the argument broadly advanced in the Evatt report. In his view opponents of privatisation face a phyrric victory. If privatisation is defeated at the national ALP conference, the government will be faced with the choice between social spending and capital injections. With 'an election within two years, I know where I would put the funds', he concludes. But has economic policy-making become simply a matter of massaging the self-interest of the electorate at the expense of the viability of public enterprises and economic infrastructure?

Crough's starting point is the rise in public debt interest (PDI) as a proportion of total government spending from 6.2 per cent a decade ago to an estimated 10 per cent in the current financial year. He argues that the government must reduce this interest level. There are a number of counter-arguments.

First, Crough is using data selectively. The correct interest burden is measured not by total public debt interest, but by net interest, which is calculated by deducting the Commonwealth's interest receipts from its interest payments. This figure is significantly less than the estimate of 10 per cent.

More importantly, both the net and total interest bills are declining fairly quickly as a share of government spending. Because the Australian dollar has strengthened beyond expectations and the government has received an unexpected revenue bonanza due to higher tax receipts and more stringent social security procedures, the decline is greater than the government's forecasts.

Crough argues that the burgeoning budget surplus has 'essentially been achieved by a combination of expenditure restraint and strong revenue growth'. He fails to mention that our long-term growth path is endangered by the spending cutbacks, that unemployment — especially among young people, who are being deprived of essential skills — remains unacceptably high, and that a broad group of wage and salary earners have not received the benefits of tax cuts and superannuation concessions and have borne the brunt of high interest rates.

The argument that public enterprises must earn a competitive rate of return or else constitute a drain on scarce funds has been put forward many times. But the Commonwealth Bank, for example, has demonstrated its ability to compete on a commercial basis. There is, however, an extra dimension to this question. Public enterprises still provide community services which would not be supplied by private enterprise. While subsidies to private firms could ensure that these services are maintained, this approach would worsen the government's budget position. Unless the critics are suggesting that public enterprises produce no social benefits, the commercial rate of return must be adjusted to reflect this social role.

If the government is to meet its aim of restructuring the economy then interest rates, the Australian dollar and private consumption must fall. Privatisation will not relieve the pressure on interest rates. Nor will it resolve budget problems. As the Evatt report spells out, in order to reduce the pressure for privatisation and constrain private consumption, the commitment to tax cuts should be reviewed.

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Trade-offs for the federal government

Greg Crough responds to the Evatt Research Centre's arguments against privatisation

AUSTRALIAN POLITICAL AND economic commentators have generally been fairly quick to pick up new jargon from other countries. One term we readily adopted from the Thatcher government in Britain was the public sector borrowing requirement (PSBR).

It's a bit strange, then, particularly given the importance of the debate about the extent of public sector borrowing in Australia and the level of the country's foreign debt, that the federal Treasurer has not used the term public sector debt retirement (PSDR). The PSDR is the mirror image of the PSBR, and refers to the extent of repayments of public sector debt. The term appears to have been first used in mid-March by the British Chancellor of the Exchequer when he introduced the latest Thatcher government budget.

Of course even though the term hasn't been used here, the strategy of retiring federal government debt, both domestic and foreign, is now well in place. The Hawke government has been able to produce quite sizable budget surpluses recently, and although asset sales have contributed to some extent to these surpluses, the results have essentially been achieved by a combination of expenditure restraint and strong revenue growth.

When you examine the federal budget papers, it is easy to see why the government would want to reduce public sector debt. Ten years ago public debt interest accounted for 6.2 per cent of total outlays, less than the proportion spent on defence and education (8.8 per cent each). In the 1986-87 budget interest was 10.6 per cent of total outlays, the third largest item of expenditure in the budget ($7.9 billion). More was spent on interest than either defence, education, or health. It increased at an average annual rate of 19 per cent in the decade, a rate only exceeded by one other item in the budget, although the most recent budget did actually reduce the figure from the year before. Even social welfare spending, which has supposedly exploded in the past few years, only grew at an average annual rate of 12 per cent.

There is little doubt that the obligation to pay interest on the debt has significantly reduced the government's flexibility in framing the budget. Without substantially reduced debt, there is little prospect of significantly reducing the proportion of outlays spent on public debt interest. Of course one way to reduce debt is to produce budget surpluses.

The other way to reduce the interest bill would be to return to the days of regulated financial markets, and require financial institutions to hold a certain proportion of their assets in the form of low-interest government debt. While such a strategy can continue to work reasonably well in a country like Japan (although it is unclear how much longer than situation will continue), it is inconceivable that the present federal government would reverse direction on such an important issue. The Hawke government continues to see financial deregulation as one of its great 'reforms'.

It is within this context that the ongoing privatisation debate needs to be examined. As is now well known, three of the largest federal government business enterprises require very substantial injections of capital, or shareholders' funds, to maintain their viability and improve their competitiveness. Qantas estimates that it will require about $600 milion in the next five years; Australian Airlines estimates its needs at about $250 million; and the Commonwealth Bank requires a staggering $1.4 billion to satisfy both the prudential regulatory requirements of the Reserve Bank and to maintain its market share.

The government has already indicated that there is no way that sums of this magnitude are going to come out of the federal budget. No government in the past has ever committed such sums to its enterprises, which is of course part of the reason why many of these organisations are under-capitalised and facing significant competitive threats.

And the government is faced with a very real dilemma on this issue. It is becoming increasingly apparent that any form of privatisation will be out of the question, even if the proceeds from the sales were used to fund the capital requirements of the enterprises. That is still Gareth Evans'