

Asset Recycling: A Spurious Justification for Privatisation

Submission to: Senate Standing Committees on Economics

Inquiry into incentives to privatise state or territory assets and recycle the proceeds into new infrastructure.

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This submission is a statement of my personal views and does not reflect the position of the University of Queensland

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Summary

The terms of reference for the inquiry are:

Incentives to privatise state or territory assets and recycle the proceeds into new infrastructure, with particular reference to:

(a) the role of the Commonwealth in working with states and territories to fund nation-building infrastructure, including:

(i) the appropriateness of the Commonwealth providing funding, and

(ii) the capacity of the Commonwealth to contribute an additional 15 per cent, or alternative amounts, of reinvested sale proceeds;

(b) the economics of incentives to privatise assets;

(c) what safeguards would be necessary to ensure any privatisations were in the interests of the state or territory, the Commonwealth and the public;

(d) the process for evaluating potential projects and for making recommendations about grants payments, including the application of cost-benefit analyses and measurement of productivity and other benefits;

(e) parliamentary scrutiny;

(f) alternative mechanisms for funding infrastructure development in states and territories;

(g) equity impacts between states and territories arising from Commonwealth incentives for future asset sales; and

(h) any related matter.

The main conclusions of this submission are

- 1. The privatisation of income-generating assets by governments has generally reduced public sector net worth, and has failed to deliver improvements in economic performance. For that reason, privatisation has been rejected by the Australian public on almost every occasion when the issue has been put to them.**
- 2. A variety of spurious accounting rationalisations for privatisation have been presented. The latest of these is ‘asset recycling’. Under this rationalisation, the proceeds of the sale of income-generating assets is notionally allocated to non-income-generating investments in infrastructure.**
- 3. The economic case for infrastructure investments is entirely independent of notional sources of financing such as ‘asset recycling’. If infrastructure investments generate services in excess of the cost of capital to the public, they should be undertaken regardless of the source of finance. The existence of a spurious source of ‘free’ capital should not be used to justify investments that would not pass the normal benefit-cost test.**
- 4. When assets are sold for their full value in public ownership, and the proceeds are used entirely to repay debt, public sector net debt is unchanged. The use of any portion of privatisation proceeds to fund current expenditure, tax cuts or non-commercial infrastructure must increase public sector net debt**
- 5. Under dividend imputation, company income tax payments are fully recouped by shareholders. Hence, the market price of state-owned income-generating assets is based on the value of earnings before interest and tax, including dividends, interest on debt, retained earnings, tax equivalent payments and competitive neutrality payments. It follows that there is no justification for a Commonwealth subsidy to privatisation.**
- 6. The system commonly described as ‘asset recycling’ is nothing of the kind. There is, however, a case for a system of asset recycling applied public investment in income-generating assets, which would result in a sustainable balance between the private and public sectors, rather than the liquidation of public assets. Such a policy would involve the allocation of risk to the agents best able to bear it.**

Asset Recycling: A Spurious Justification for Privatisation

Introduction

The privatisation of income-generating assets by governments has generally reduced public sector net worth, and has failed to deliver improvements in economic performance. As this fact has been recognised, a variety of attempts have been made to repackage privatisation policies in a more appealing form. ‘Asset recycling’, in which the proceeds of the sale of income-generating assets is notionally allocated to non-income-generating investments in infrastructure.

This submission presents a critical analysis of the asset recycling model being proposed. An alternative, sustainable model is presented.

The submission is organized as follows.

Section 1 is a critical assessment of experience of privatisation, focusing on fiscal outcomes and the rise of public opposition. Section 2 describes proposals for ‘asset recycling’. It is argued that the ‘recycling’ metaphor is inaccurate and misleading. Section 3 restates basic principles for public infrastructure investment, and shows that ‘asset recycling’ programs are likely to violate these principles. Section 4 focuses on public assets and debt and the risk that ‘asset recycling’ will reduce public sector net worth. Section 5 deals with the tax treatment of asset recycling. It is shown that the sale of state-owned assets is fiscally neutral under a system of dividend imputation and therefore that no subsidy is justified. Section 6 presents a genuine system of asset recycling would involve a sustainable stock of income-generating public assets, managed according to the principle that risk should be allocated to the party best able to bear it. Finally some concluding comments are offered.

1. Experience of privatisation

For most of the 20th century, Australia, like other developed countries adopted a ‘mixed economy’ model, in which public enterprises played a substantial role in the provision of a wide range of services, particularly infrastructure services. Some of these services, such as roads, were generally provided free of charge, while others, such as electricity and other

utilities, were provided by statutory authorities which covered their capital and operating costs through the sale of their services.

The mixed economy was highly successful, giving rise, in the decades after 1945 to the longest sustained period of full employment and strong economic growth ever experienced by developed market economies. However, following the economic crises of the 1970s, a reaction against the mixed economy led to the adoption of policies of privatisation.

In the English-speaking world, the push towards privatisation began in the UK under the Thatcher government, and was followed in Australia and New Zealand beginning in the late 1980s.

After more than 30 years of experience, it is clear that privatisation has not, in general delivered the promised outcomes. It has not improved the fiscal position of governments, nor has there been, in general, an improvement in standards of customer services or a lowering of prices relative to the previous trend. As a result, policies of privatisation have proved increasingly unsaleable.

Fiscal outcomes

The most common reason governments in developed countries have privatised assets is because of the illusory belief that the money raised in this way will allow them to increase public spending or cut taxes without incurring additional debt. Such misleading accounting was employed extensively by governments in the 1980s, including the Thatcher government in the United Kingdom, and the Hawke–Keating government in Australia.

The most recent instance of this belief is the asset sales program put forward the Newman LNP government in Queensland, and rejected by the electorate in the recent state election. Asset sales were put forward as the funding source for around \$12 billion in expenditure on consumer subsidies and investments in commercially unsustainable projects such as the Abbot Port redevelopment and rail line.

It was gradually recognised that a policy of selling assets to finance current expenditure was unsustainable. Economists, at least when they were thinking clearly and speaking honestly, were as one in rejecting the most popular political reasons for privatization: as source of cash

for governments or a way of financing desired public investments without incurring public debt.

It is a basic principle of economics that the value of a capital asset is determined by the flow of earnings or services it generates. The cash gained from selling public assets comes with the cost of forgoing the earnings it would have generated in continued public ownership. In a world where both governments and markets were perfectly efficient the cost would be exactly equal to the benefit and privatization would not change anything. In reality, most privatizations have reduced public sector net worth, either because the assets have been underpriced, or because the proceeds have been dissipated in current expenditure or economically unsound investment projects.

This experience has done little to dilute the enthusiasm of policy elites for privatisation. However, the general public has been more perceptive and is now resolutely hostile to privatisation.

Public opposition

Privatisation has been, from the start, an initiative of policy elites, with no popular groundswell of support. Nevertheless, in the 1980s, the majority of the general public did not have strong views on the subject one way or another. A study by Jonathan Kelly and Joanna Sikora (2002) showed that in 1986, views on the privatisation of Telstra were about evenly divided.

Advocates of privatisation assumed that the benefits of competition and private ownership would be obvious, and that what they saw as ‘emotional’ attachment to iconic assets would fade over time. In fact, the reverse has been the case. Public opinion against privatisation has hardened steadily over time, and with experience. By 2002, when the privatisation of Telstra was complete, Kelly and Sikora found that 70 per cent were opposed and only 16 per cent in favour. Similar views applied even to firms like the Commonwealth Bank and Qantas that had been privatised for years.

Opposition was even stronger in the case of Australia Post, the only business in the study still in full public ownership. This position has not changed. After briefly flirting with privatisation, the newly elected Abbott government was forced to repudiate the idea, even

though it is almost certain to be recommended by the government's promised Commission of Audit.

Opposition has only grown since then. Polls taken under the Bligh government in Queensland showed opposition by 80 per cent of the public to asset sales. In regional Queensland, over 90 per cent of the public opposed the sale of the QR rail freight business.

Numerous Australian elections have been fought primarily on the issue of privatisation, with generally catastrophic outcomes for supporters of the policy. A brief listing

* Queensland 2012: The Bligh Labor government, which undertook an asset sales program in defiance of its own 2009 election commitments was defeated, losing all but 7 seats in a Parliament of 89

* Queensland 2015 The Newman LNP government, which proposed large scale asset sales was defeated, reversing its overwhelming victory

* NSW 2010: The Keneally Labor government, which privatised electricity assets, was defeated, losing 32 of its 52 seats in Parliament

* NSW 1999: The Liberal Opposition, proposing privatisation of the electricity industry, was defeated in a landslide losing 13 of 46 seats and receiving only 33 per cent of the popular vote. The Liberals did not regain office until the 2010 election, when the parties had switched sides on this issue

* Tasmania 1998 The Rundle government, proposing privatisation of the HEC, was defeated. The Liberal party remained in Opposition until 2014

* South Australia 2002 The Liberal government which had privatised the electricity industry was defeated. The Liberals have yet to regain office

Other elections in which unpopular privatisation proposals played a role include the 1993 Federal election (along with the GST, privatisation was a central element of the Coalition policy) and the 2001 ACT election (the Liberal government had sought to privatise the electricity and water provider ACTEW).

Australians are not unusual in their opposition to privatisation. Throughout the English-speaking world, privatisation has been imposed by policy elites on an unwilling public. In the UK, for example, 70 per cent of the public support renationalisation of

electricity, gas and water services, and similar proportions support complete renationalisation of the railway industry (the rail track industry has been renationalised, and a PPP arrangement for the London Underground abandoned).

Opposition to privatisation is similarly strong in Canada. Even in the United States where public ownership of business enterprises is rare, proposals for the privatisation of the Social Security system were so politically toxic that they had to be rebranded as “choice” and still proved to be politically unsalable.

A striking irony of Australian privatisation is that many publicly owned assets have been sold to corporations owned by foreign governments, from countries which would not themselves allow foreign ownership of critical infrastructure. Examples from the electricity sector include Singapore, France and (pending approval) China.

2. Asset recycling

It has been commonplace for governments undertaking privatisation to tie the proposal to some item of public expenditure that would otherwise fail a benefit-cost test. In some cases, such as the consumer subsidies proposed by the LNP in Queensland, these are politically popular outlays designed to offset public opposition. In other cases, they are pet projects of the government in question, or perhaps of the minister in charge of the asset sale, with net costs concealed by a package involving privatisation.

Queensland again provides an example. The main infrastructure project undertaken by the LNP government in its first term was the demolition of the old but functional office building in which the Premier and other senior ministers worked, and its replacement by a new building with an estimated cost of \$650 million. Clearly such a proposal could never have survived political scrutiny if it was funded through the normal budget crisis, particularly at a time of alleged financial emergency. But by wrapping the project up in a complex deal involving land transfers and casino gambling rights, it was possible to claim that the project was being undertaken ‘at no cost to the taxpayer’.

The idea of asset recycling is, in essence, an attempt to systematise and subsidise this procedure. Rather than once-off deals in which asset sales are packaged with expenditure project, a general procedure is suggested to subsidise such packages.

The idea of recycling is that a resource, used once to produce some good or service such as a newspaper or container, can be reclaimed and reused. Ideally, the same resource can be reused many times, reducing the need for new supplies. 'Asset recycling' has nothing in common with this process. Income-generating assets are valuable precisely because they generate income. Selling the assets and spending the proceeds on current or capital items that generate no flow of income, and cannot be justified by ordinary cost-benefit analysis is not, in any meaningful sense, recycling.

A closer analogy would be the strategy pursued in China's 'Great Leap Forward' in the late 1950s, in which cooking pots and other valuable items were fed into backyard smelters in order to meet wildly optimistic production targets for steel. In a sense, of course, these items were recycled, but not in a way that enhanced the welfare of the Chinese people.

3. The economics of public infrastructure

The economic principles for sound investment in public infrastructure are well understood. The key points are

- (a) An investment is justified if and only if the net present value of its benefits, evaluated using the public sector cost of capital, exceeds the capital cost
- (b) The source of funding for any particular project is irrelevant when assessing its desirability

These principles are not always adhered to in practice. Assessment of costs and benefits inevitably involves an element of political judgement.

Nevertheless, long experience has shown that consistent application of the principles of benefit-cost analysis achieves better outcomes for the public than does a 'pork barrel' system in which the provision of any particular project depends on the availability, or otherwise, of a nominated 'pot of money'.

The idea of asset recycling, in which specific balance sheet transactions are identified as a funding source for favoured projects runs the risk of violating the core principles of public infrastructure investment. Projects are selected on the basis of eligibility to attract financing from the proceeds of asset sales, rather than being evaluated on a standard benefit-cost basis.

Moreover, given the political unpopularity of privatisation, there is considerable pressure to fund politically attractive projects, rather than those with the greatest long-term benefits.

4. Asset sales, public debt and public sector net worth

Net worth may be measured as the difference between the value of assets and the value of liabilities, including debt. In general, assets may be valued according to the market price. So, in general, the sale of an asset at market value, with the proceeds used to repay debt or acquire new assets, has no effect on net worth. The following qualifications and exceptions should be noted

(i) If the value of the asset to its current owner is less (or more) than its market value, the sale of the asset will effectively increase net worth

(ii) If the asset is sold for (less) more than its market value, the sale of the asset will reduce net worth

(iii) If sale proceeds are used for current expenditure, or for the purchase of assets that do not generate a flow of services commensurate with their cost, the sale of the asset will reduce net worth

The main danger with ‘asset recycling’ relates to point (iii). Asset recycling is commonly seen as a way of financing projects that would otherwise not proceed, implying that they do not pass the relevant benefit-cost test. Under these circumstances, the value flow of services from the project is less than would have been obtained by repaying debt or making a cost-justified investment. It follows that public sector net worth will decline.

5. Tax treatment of asset recycling

Corporations owned by state governments are exempted from company income tax. For reasons of competitive neutrality they are required to make a tax equivalent payment to the state government, which is foregone under privatisation. It has been argued that, under these conditions, there is a distorting bias against decisions to sell assets. For this reason, the Australian government has introduced a discretionary subsidy of 15 per cent, to be paid to state governments that sell income-generating assets and reinvest the proceeds in non-income generating infrastructure.

The reasoning behind this subsidy is unsound. The benchmark case for comparison is that of a company with exclusively Australian shareholders that pays out all its earnings (after interest and tax) in fully franked dividends. The (actual and intended) effect is to avoid double taxation of company earnings. The shareholders of a company operating in this fashion are in exactly the same position as a state government. Company income tax payments are wiped out by income tax credits.

It is true that Australian shareholders are subject to personal income tax, while state governments pay no income tax on their revenue from any source. But this is entirely consistent with tax neutrality. The personal income tax is precisely that, and is not applicable to any state or local government.

The benchmark case is one of many corporate structures available to buyers of state government assets. Other things equal, the buyers will choose the most tax-effective of the structures available, of which the benchmark case is only one. Many corporations employ complex structures involving international transfer pricing which have the effect of reducing tax to levels lower than that applicable under the benchmark structure.

Hence, if anything, the tax structure distorts decisions in favour of privatisation.

6. A sustainable system of asset recycling

As argued above, the system commonly described as ‘asset recycling’ is nothing of the kind. There is, however, a case for a system of asset recycling applied public investment in income-generating assets, which would result in a sustainable balance between the private and public sectors, rather than the liquidation of public assets. Such a policy would involve the allocation of risk to the agents best able to bear it.

There is considerable evidence that the public sector has a greater capacity to bear the demand and regulatory risk associated with some kinds of projects (for example, ports) and that this risk is greatest in the early years of operation, after which revenue streams become predictable. There is also considerable pressure on the public sector to keep its gearing ratio (debt to assets).

In this context, an asset recycling problem might undertake the development of an income-generating project in the following sequence.

1. A benefit-cost analysis shows that a new project, such as a port would yield a positive net present value
2. The government contracts for its construction on a fixed price basis (with rewards and penalties for early or late completion).
3. When the port is built, it is operated as a government business enterprise until the demand risk settles down and regulatory issues are resolved
4. Then it is sold and the proceeds are used to build a new port, or some other piece of income-generating infrastructure.

So, at any given time, construction companies are bearing construction risk, the government is bearing demand risk and the private sector owns and operates various 'mature' assets. This process of recycling can, in principle, be carried on indefinitely

To restate, arguments for asset recycling of this kind, are irrelevant to the proposals actually under consideration, which involve selling income generating assets and notionally allocating the proceeds to projects that generate no income. For example, according to Warren Truss, the NSW government:

have sold the Port of Botany and they have raised a lot of money from that which is now being put into road systems. They're interested in selling the Port of Newcastle and that is be used to revitalise the central city of Newcastle.

Clearly, the new investments will not generate income and offer no potential for recycling. This is, therefore, an unsustainable policy which cannot properly be described as recycling.

Concluding comments

Privatisation has, in general, failed to live up to the promises made by its advocates in the 1980s and 1990s. For this reason, the policy has become politically unpopular. 'Asset recycling' is an attempt to bundle this failed policy with politically attractive, but economically dubious projects, in order to increase the appeal of the package. This approach, like previous attempts to make privatisation palatable is doomed to failure. A genuine approach to asset recycling would involve a sustainable stock of income-generating

public assets, managed according to the principle that risk should be allocated to the party best able to bear it.