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State stake needed in rail and power

By KEITH RANKIN*

What's wrong with Tranz Rail? And why has the supply of electricity not kept pace with demand? The answers to both questions are essentially the same.

Private companies invest for a private return. Enlightened publicly owned utilities, on the other hand, share the Government's goal of maintaining a high rate of sustainable economic growth.

The problem is ubiquitous but remains poorly understood. The technical term is "positive externality", meaning that much of the benefit from new investment shows up, through lower prices, as a gift to the wider public.

Because private companies are in the business of making profits, not giving gifts, they are reluctant to make such investments, even when those investments may be critical to the well-being of the nation in which they operate.

Before discussing Tranz Rail and Mighty River Power, I will use agriculture to illustrate two key points.

First, let's imagine that Auckland is dependent on potatoes from the Franklin district. What would happen, then, if a severe weather bomb struck the Pukekohe area, ruining a large proportion of each farmer's crop?

Auckland people would be clearly worse off because they would have to pay much more for their potatoes. Such a weather bomb would, however, make Pukekohe potato farmers better off. Their losses from a reduced crop would be more than outweighed by their gain from higher prices.

This suggests that potato farmers would be better off if they did not expand their businesses. Such supply restraint does not happen, however, because individual farmers know that increased production by just one farmer is not enough to influence the market price.

The process of competition, therefore, causes market gardeners and their ilk to invest, even though they would be collectively better off if they did not invest. Indeed, the best way for potato farmers to maximise their revenue while minimising their costs would be to form a cartel, or union, and then to restrict supply.

My second insight from agriculture relates to the important distinction between farmers and landlords. In New Zealand most farmers are also landlords. In the 1890s and 1900s our most passionate debates were about the merits of freehold versus leasehold farming.

The freehold system prevailed because it was clear to farmers that it was freehold that would secure for them the returns to their individual investments.

In most Third World countries - and in much of Europe - farmers who produce for the market pay rent to separate landlords. If one farmer innovates or invests, he raises his revenue in the short run. But when others follow suit the landlords cream off the extra revenues as rent.

In other words, when there is a general increase in farm productivity, there is no long-term gain to the farmers - only to the landlords to whom they pay rent. This was the central issue upon which modern (that is, classical) economics was founded.

Countries such as New Zealand were able to break the impasse. New Zealand farmers had every incentive to invest because they paid rent to themselves. Historically, the high incomes of farmers here have been returns to land ownership. Progressive freehold farmers gain more in increased land rents than they lose from decreased profits.

Unlike potato farmers, Tranz Rail is a monopoly. As a monopoly, it knows that an expansion of its capacity to move freight will reduce the prices it gets. Tranz Rail, therefore, has an incentive to undersupply in an attempt to keep prices high.

Indeed, the only reason that a profit-maximising rail freight company has for investing in new capacity is the fear of losing market share to road transport and coastal shipping.

However, the economy will benefit significantly from cheaper rail freight and from an increase in rail's share of the domestic transport market. A loss to Tranz Rail's shareholders could be offset by a much larger gain to transport users.

Renationalising Tranz Rail would enable its new owner - the people of New Zealand - to recoup the investment cost from higher tax revenues. In other words, under public ownership the owner gains more in increased tax than it loses in profits.

The same argument applies to Mighty River Power. As electricity prices rise, the rain in the north must be giving windfall profits to this publicly owned company. Inasmuch as it (as a state-owned enterprise) pretends to be a private company, investment in significant amounts of additional generation capability will create more additional costs than additional revenues.

The public owners of Mighty River Power will gain more, however, from having lower electricity prices. More production by electricity users means more tax revenue to the Government.

Publicly owned utilities are like freehold farmers. The owner gains more as a landlord than is lost through increased investment costs.

Established privately owned utilities are, however, like tenant farmers, reluctant to increase capacity.

Someone else captures the benefits when they incur costs to increase the supply of whatever they produce.

I may have been too negative about privately owned utilities. There are some efficiency benefits from private ownership. The arguments for privatisation are not wholly erroneous.

The best balance may be something like an 80:20 public-private split. Air New Zealand stumbled into such an arrangement. As a result, since its 2001 nadir, it has done

surprisingly well for both its shareholders and for the public.

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