

# ANALYSIS OF THE ECONOMIC RATIONALE FOR THE GOVERNMENT'S ASSET SALES PROGRAMME

*Ian Harrison and Arthur Grimes examine the financial considerations involved in assessing the Government's asset sales programme.*

## Executive Summary

There are two main reasons why a government may wish to sell assets. The first is based on balance sheet considerations, such as the sustainability of various debt-equity ratios; while the second is based on a wealth maximisation argument, that the Government will receive more from the sale of its assets than from retaining ownership.

The balance sheet arguments may be broken down into two separate concerns:

1. When debt is so high that lenders refuse to refinance the debt and/or the debt cannot be serviced, then assets simply have to be sold.
2. Debt ratios may be acceptable under current conditions but may expose the country to unacceptable costs if there is an adverse economic shock. In turn, this risk increases current borrowing costs.

The first of these concerns is of little current relevance to New Zealand – lenders are prepared to advance money to the New Zealand Government and to New Zealand corporates, even at current debt levels.

However, the country's relatively high net external debt level is a factor that may be of concern in limiting the options for adjustment if the country faces a major adverse economic shock. This concern provides a rationale for asset sales to foreigners, since if the Government sells an asset to a foreigner, both the Government's debt and the country's foreign debt are reduced. If, in the future, the country faces a major adverse economic shock, a reduced debt ratio will enable the Government to facilitate adjustment to the shock more easily by undertaking a temporary programme of offshore borrowing. Thus a reduction of debt now acts as an insurance against the worst effects of future adverse shocks. However, an asset sale to a domestic purchaser is likely to have only a very limited and indirect impact on the country's total foreign debt and so does not substantially alleviate these concerns.

In terms of borrowing costs, the country's relatively high debt ratios are likely to have increased borrowing costs of both Government and New Zealand corporates. While the extra costs do not appear to be so high as to compel a large-scale disposal of assets, they remain a valid factor to be considered.

The wealth maximisation argument is based on the principle that if an enterprise's profitability is higher in the private than the public sector then Government will generally increase its wealth by selling the asset. The reason for this increase in wealth is that bidders will generally offer a price based on the expected profitability of the enterprise in private hands, which will exceed the value to Government of continuing to operate the enterprise within the public sector. This argument provides the principal rationale for asset sales.

However, for this argument to be valid, it is important that the enterprise will indeed be more profitable in private rather than public hands – and this question is an empirical matter that must be decided on a case by case basis. Where private ownership will be more profitable, Government must still ensure that this greater profitability is factored into the price received for the asset. In the case of the sale of an SOE with perceived monopoly power, a bidder faces the risk that a future government may regulate its activities and so affect its future profitability. Given the controversial nature of foreign ownership of former SOEs, a foreign bidder may face an additional risk that a future government could force the enterprise to be sold to domestic owners. These political risks mean that a bidder may discount the estimated earnings of the enterprise relatively highly so lowering the bid price. Because of these types of risks, Government must in each case assess whether the best bid exceeds its own valuation of the asset in deciding whether to sell the asset.

## Introduction

A good deal of confusion has surrounded the public debate on the economic rationale for the Government's asset sales programme. In order to help reduce this confusion, this article provides a framework for public debate of the issues; the purpose of the article is to outline this

framework, rather than to reach definitive conclusions on the merits or otherwise of asset sales. The focus is on outlining the major financial considerations involved in assessing the programme; other social goals are not considered.

Simplifying somewhat, there are two main sets of economic reasons why a government would want to

sell assets. The first set is based on the structure of the Government's balance sheet. In a manner analogous to a corporate with an excessive debt to equity ratio, it may be argued that the Government has an 'unbalanced' book, and that asset sales are required to reach some preferred debt to equity position.

The second argument is that the

Government will receive more from the sale of its assets than from retaining ownership. In other words, the present value of the future flows of returns to the Government is worth less than the sale price of the asset, and so the Government will maximise its wealth by selling. It is an argument that may apply to all or only some of the Government's business assets, and essentially has to be decided on a case-by-case basis, in the light of the prices offered by the best prospective purchaser and the value the Government places on each asset.

### Balance Sheet Structure Arguments

The 1988 Budget contained the following explanation of one of the Government's reasons for selling assets: "This announcement [to sell state assets] was made against the background of the New Zealand public debt to gross domestic product ratio being one of the highest amongst OECD countries . . . The high public debt causes major budgetary problems in that interest payments either squeeze out expenditure, require higher taxes and/or require further borrowing. It also damages economic performance and increases the Government's vulnerability to shocks in financial markets."

Essentially, this is a balance sheet structure argument. The first part of the statement suggests that Government's relatively high debt to Gross Domestic Product (GDP) ratio is, in itself, costly, with the implication that, like a corporate in a similar situation, debt must be reduced. In assessing this argument, we can think of two broad reasons why a corporate might wish to sell assets to retire debt. In descending order of concern they are:

- Lenders refuse to refinance the existing debt, and/or the borrower does not have the cash flow to service the debt. This is the firesale situation - assets simply have to be sold.

- Debt levels are acceptable under current conditions but may expose the firm to unacceptable adjustment costs in the event of an adverse shock, since borrowing opportunities may then be limited because of the high debt ratio. If this risk is perceived by lenders, the corporate's cost of borrowing will rise. Further, the marginal cost of borrowing will be higher than the average rate, and may be higher than the marginal return on assets. Debt is therefore retired both as an insurance against future adverse shocks and in order to reduce current borrowing costs.

In assessing these factors, it is necessary to consider which measures of debt are most important for current purposes. The country's total external indebtedness (i.e., private plus public sector debt held by foreigners) is most important since, if this debt ratio is high, the country as a whole may not be able to service its foreign interest bill; thus default is a possibility. Government's total indebtedness may also be important since a high debt ratio could lead to the Government being unable to service or roll over its debt or may force an undesirable tax increase in future. (The Government's foreign debt position is of a much lesser order of concern when dealing with the potential for default since this ratio adds nothing to the two potential default scenarios already outlined.)

We are faced with the problem that governments and countries do not have published balance sheets. To get around this difficulty, debt to GDP ratios are sometimes used, as in table 1, as a rough proxy for the relative indebtedness of governments and countries. Ideally, we require data for the net debt position (i.e., gross liabilities less gross assets) of a government and a country when making such a comparison. Unfortunately, however, only gross debt data are generally available for governments. While acknowledging the conceptual inadequacies involved in using these data, we in-

clude, in the first column of table 1, a comparison of New Zealand's gross total central government debt with the most recent figures available for sixteen other Western countries.

The quality of net external debt figures is open to even greater reservations than the Government debt figures, since the inclusion of assets and liabilities can vary markedly across countries. The OECD has, however, recently attempted to measure net external debt for a number of countries, and we reproduce these figures in the second column of table 1, again mindful of the inadequacies in the data. Table 1 also includes the latest Moody sovereign debt ratings for a number of countries, together with the interest rate spread over U.S. Treasury bills for these countries' short-term U.S. dollar debt.

It is clear that New Zealand is not in the situation in which immediate asset sales are required in order to prevent potential lenders from refusing to lend to the country. While New Zealand has the fifth highest government debt ratio and third highest external debt ratio of the listed countries, lenders are prepared to advance money to the New Zealand Government and to New Zealand corporates, and have lent funds over the last year when the country's total debt to GDP ratio was higher than it is now. No case can be made either that the New Zealand Government or that the country as a whole *has* to retire debt.

It can, however, be argued that New Zealand might be in the second situation, in which assets should be sold and debt repaid so as to reduce the Government's or the country's vulnerability to future shocks, and to reduce borrowing costs. First, consider the Government's financial position. By selling assets, the Government is removing a source of uncertainty from its future cash flows - the uncertainty in the future profit stream from the assets. In fact, in terms of the Government's balance sheet, this uncertainty is not of major concern, since Government can always change its taxation pol-

Table 1  
Debt Indicators<sup>1</sup>

U.S. Points	Gross Central Government Debt as % of GDP	Net External Debt <sup>2</sup> as % of GDP	Moody Sovereign Debt Rating	Interest Rate Spread Over Basis
Australia	26.5	40	—	—
Belgium	95.9		Aa1	110
Canada	42.3		—	—
Denmark	86.5	44	Aa1	107
Finland	13.9	15	—	—
Germany	21.7		—	—
Iceland	30.7	59	—	—
Ireland	127.8	82	Aa3	112
Italy	54.8		—	—
Netherlands	55.6		—	—
New Zealand	65.9	53	Aa3	112
Norway	25.9		—	—
Portugal	—	35	A1	127
Spain	34.8	11	Aa2	112
Sweden	58.9	22	Aaa	107
Switzerland	12.9		—	—
U.K.	47.4		—	—
U.S.	43.7		—	—

Source: IMF Government Finance Statistics, New Zealand Budget, OECD Economic Surveys (New Zealand 1988/89)

<sup>1</sup> Most recent available statistics in each case.

<sup>2</sup> Public plus private sector.

icies so as to offset the effects of changes in the profit stream on its financial position. Hence the major brunt of any uncertainty is borne by taxpayers, although the effects can be spread over current and future taxpayers through the use of a judicious borrowing programme. The effect of this uncertainty on current taxpayers is therefore not of crucial importance provided Government is still able to borrow in the face of an adverse shock so as to spread its effects. In general, provided the country's debt position is sustainable, Government will be able to borrow in such circumstances.

Attention is therefore turned to the case in which asset sales are designed to reduce the country's vulnerability to shocks. This argument has relevance especially if the assets

are sold to foreigners. A country with a low level of borrowing will be better able to borrow on the international market to spread the impact of a major economic shock than a highly indebted country. Essentially, this is an insurance argument, in which the Government, through its actions, aims to reduce the country's external debt (and increases foreign equity participation in New Zealand) in case there comes a time when the country has to borrow substantially to spread the impact of an adverse national economic shock. The argument relies crucially on reducing the country's total debt. This reduction will generally occur through asset sales to foreign interests, but will occur only indirectly, and probably only to a very limited extent, through asset sales to dom-

estic interests.<sup>1</sup> In addition, the importance of the argument depends both on the perceived impact of adverse economic shocks and on their probability.

In terms of current borrowing costs, the country's relatively high debt ratios, in conjunction with the possibility of future adverse shocks, has almost certainly been a factor in the downgrading of New Zealand's credit rating which, in turn, is likely to have increased New Zealand's

<sup>1</sup> The channel whereby a sale to a domestic purchaser may indirectly reduce foreign debt is that if the purchaser funds the purchase through domestic borrowing, then other investors are forced to switch from domestic to foreign borrowing, but an aversion to foreign borrowing may result in a reduction in their total borrowing requirement. The total increase in foreign borrowing may therefore be less than the foreign debt that is repatriated by Government, so resulting in a net reduction in the country's foreign debt position.

cost of borrowing. However the table demonstrates how little the spread in ratings translates into short-term borrowing costs. The spread of 112 for the New Zealand Government compares with that of Aaa rated Sweden at 107; i.e. Sweden's funding costs on short-term U.S. dollar debt are only 1/20 per cent lower than New Zealand's. Even allowing for the fact that credit risk margins on longer term debt tend to be higher than on short-term debt, and that a reduction in government risk margins would translate also to reduced private sector borrowing costs, the repayment of a substantial amount of foreign debt is unlikely to result in a substantial reduction in funding costs for New Zealand borrowers. Thus, while being a factor to be considered, borrowing cost reduction does not appear to be a compelling argument for asset sales.

An additional part of the Budget explanation of the debt sales programme – and one that has been repeated frequently in public discussions – is that the interest burden is excessive, so crowding out other expenditure, adding to the taxation burden and/or increasing the deficit.<sup>2</sup> While this contention is true relative to a situation in which there is a lesser amount of debt, the issue is what to do about the present level. In terms of easing the pressure on other expenditures, or reducing taxes, asset sales may not necessarily be beneficial – it depends on the earnings rate (under government ownership), the debt service charge

and the potential sale price of the asset being sold. This matter is dealt with more fully in the next section.

### The Wealth Maximisation Arguments

There are two principal factors to be considered in deciding whether or not the sale of state assets will increase the Crown's wealth. First, if the profitability of an enterprise is higher in the private than the public sector then, provided this increased profitability is factored into the sale price, the Government will generally increase its wealth by selling the asset. This rationale formed a prominent part of the 1988 Budget explanation for asset sales. Secondly, the valuation of an asset may differ between the public and private sectors, for instance because of taxation reasons or because the Government may have a different discount rate from the private sector. However, as noted below, even if the Government has a lower discount rate than the private sector, it does not necessarily mean that it should retain ownership of existing state assets. The issue of share ownership versus control becomes important in this case.

### Efficiency Factors

With respect to the efficiency arguments, there are a number of reasons why an asset might be more valuable to a prospective purchaser than to the Government. The first relates to the particular fit between the purchaser's business and the Government's assets. Because of factors such as economies of scale, vertical integration possibilities, and the application of particular skills or processes to the Government's assets, the purchaser may place a higher value on even a well managed SOE and may be prepared to bid accordingly.

The second reason relates to the

superior incentive and monitoring structures that are generally perceived to operate in the private sector. In part, private sector processes may be replicated within the SOE structure. Professional management, with incentives to perform, can be hired, 'commercial' operating disciplines can be imposed, and the removal of the government guarantee on borrowing should impose the discipline of bank monitoring and the ultimate sanction of bankruptcy.

However, the latter sanction may not be as credible as in the private sector, since Government may intervene to forestall an SOE bankruptcy in order to minimise potential political problems. In addition, an SOE may not be able to replicate private sector incentive structures completely, since senior management in the private sector are often required to accept a major equity stake in their firm, an option which is not available within a fully state owned SOE. Further, the SOE situation does not replicate sharemarket monitoring or the continued threat of unfriendly takeover which should act as a spur to management. It is true that Government, as shareholder, does monitor its SOEs but Government monitoring alone does not appear to have been an effective spur to efficient management in many public bodies in the past. However, the monitoring ability of the New Zealand sharebroking industry must also be held in some doubt given its record prior to the October 1987 share crash. The threat of aggressive takeovers of private sector firms is likely to provide a more substantive incentive to manage firms efficiently, since such takeovers are a common method of replacing inefficient management in countries such as the U.S. and U.K., although they are less common in Germany and Japan. (Providing the Government does not rule out asset sales, the threat of voluntary disposal by Government still, however, hangs over management.)

The third reason for a poorer performance by a SOE may be political

<sup>2</sup> Note that the real economic burden of Government debt is significantly lower than the \$4.9 billion gross cost for the 1987/88 year. A part of the debt is backed by financial assets – the earnings on which reduce the net interest burden for that year to around \$3.4 billion (Budget Table 9). The burden is further reduced when account is taken of the inflationary diminution of the real value of the debt. This effect amounted to about \$1.4 billion in 1987/88 giving a net real cost of around \$2 billion. Assuming, over the long term, that the real rate of interest will average about 5 per cent this annual cost is similar to the expected future real cost of debt servicing if the real debt level was to stay at March 1988 levels. This debt servicing cost represents 6.3 per cent of Budget Table 2 receipts and 2.7 per cent of GDP. An assets sales programme of \$14 billion can be expected to decrease this burden by \$0.7 billion.

risk. While it might be conceded, in the absence of political intervention, that some SOEs could perform as well as the private sector, state ownership may give some future government a ready lever to intervene and so reduce expected returns.

A point to note is that not all political risk can be removed by asset sales, and, in some cases, political risk may even be exacerbated through private sector ownership. If there is an element of political controversy surrounding the sale of an asset then the purchaser is likely to factor in a discount for political risk. A future government can introduce regulations to restrain pricing or alter other commercial practice and, in the extreme case, privatisation can be reversed. In addition, while there may be a reasonable presumption that in competitive industries private ownership will lead to efficiency gains, the same conclusions cannot be drawn in the case of monopolies. The inefficiencies caused by the regulation of a private sector monopoly can exceed the inefficiencies arising from government control of the industry, and this source of inefficiency may materially affect the price offered by prospective purchasers.

The existence of these political risks in no way lessens the argument that in many cases state enterprises may be run more efficiently within the private sector. However, they do provide a note of caution that efficiency improvements cannot be expected in all cases, so that a case-by-case approach to the issue must be adopted.

### Valuation Factors

Although the private sector may, in many cases, be able to manage the SOE assets more efficiently than the Government, this is not a sufficient reason for an asset sale. The Government should sell only if these efficiency gains are reflected in a bid price for the asset that exceeds the value the government itself places on the asset.

It is generally considered that the value of an asset to the Government is the present discounted value of the expected future earnings stream under government ownership. There is therefore the question of determining the appropriate discount rate. The logical answer is that it should be the rate that the private sector would place on an asset with similar risk characteristics. One rationale for this answer is that we can characterise the State's assets as a mutual fund, owned by its 'shareholder' citizens. The argument is that there is no reason why these shareholders should value the assets in this mutual fund any differently than they would a similar asset in the market place; hence the appropriate discount rate is the market rate.

An alternative rationale is that the Government has the option of selling an SOE and using the proceeds to purchase small parcels of shares in firms (domestic and foreign) in the same risk class. Thus the opportunity cost must be measured by the discount rate used in valuing these other firms. This observation brings us to the distinction between share *ownership* versus *control*. Government can decide the total value of its desired share portfolio on the basis of the balance sheet considerations (discussed earlier) and on its attitude towards risk. Even if Government preferred to adopt a riskier position than did the private sector, and so preferred to have a major exposure to the share market, there is no need for Government to control a particular firm (other than in the monopoly case already discussed), especially if such control decreases the efficiency of an enterprise. Instead, if the Government wishes to own a share portfolio (for instance, to save for future superannuation commitments), it could purchase a diverse share portfolio without adopting a controlling stake in any firm, so adopting its chosen exposure to the share market without invoking the inefficiency costs caused by state control of industry.

Once the Government decides to

sell an asset, it is important that the list of possible buyers should not be significantly restricted; in particular, it should not be restricted solely to New Zealand firms. The small size of the New Zealand capital market means that the domestic market is unlikely to be able to handle the prospective asset sales programme while maintaining respectable gearing, particularly given the current state of the share market. The resulting lack of capital in this circumstance would almost inevitably mean that bids would be lower than if the nationality of bidders was not restricted.

A final caveat is that while widening the list of bidders increases the chance of a fair bid, the market for large assets may remain imperfect; it should not automatically be presumed that the highest bid necessarily represents good value for the Government. In particular, foreign bids may be biased on the low side because of a perception that New Zealand assets are more risky than comparable assets in the foreign firm's home country. This view may be because of a lack of familiarity with New Zealand or, more importantly, because of a perception of a high level of political risk in the purchase. Because asset sales are controversial, particularly those with some perceived monopoly right and those which are sold to foreign interests, foreign buyers may increase the premiums factored into their discount rate on the assets. If this element is substantial enough it could outweigh any gain to Government through its share of future efficiency savings.

### Conclusion

A decision on the desirability of asset sales must be made principally on a case-by-case basis. The main balance sheet rationale for a substantial programme of asset sales is to provide some insurance against future national shocks, although this

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case has relevance mainly for sales to foreign interests.

The principal rationale for asset sales is a presumption that on efficiency grounds government control of assets is not optimal. However, this rationale may not extend to the case of SOEs with some monopoly

power, in which case public ownership may present less political risk than if the government were to regulate a privately owned monopoly. This potential regulatory risk, which could be exacerbated if a foreign bidder is involved, may mean that the bidder will discount the esti-

ated earnings of the enterprise relatively highly so lowering the bid price. Thus, while encouraging foreign bidders, government must still assess, in each case, whether the best bid is greater than its own valuation of the asset. ■