Chapter 18
Natural monopoly: public or private?

Nationalisation and privatisation

• Nationalisation
  – the acquisition of private companies by the public sector

• Privatisation
  – the return of state enterprises to private ownership and control
Natural monopoly

occurs when there is an industry with such economies of scale relative to market demand that only one firm can survive.

The monopoly would produce where $MC = MR$, with output $Q_m$ and price $P_m$ and make the profits shown.

From society's point of view the optimum position is at $P_c Q'$, where $MSB = LMC$ but the monopoly would make a loss if forced to produce at this point, with $LAC > AR$.

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Natural monopoly (2)

**Alternative pricing policies:**

1. **Average cost pricing:**
   - Firm sets $P = LAC$ at point $G$; deadweight loss reduced to $GHE$.

2. **Two-part tariff:**
   - Firm makes a fixed charge to cover the loss made by producing at $Q'$ (the green rectangle), and a variable charge ($P_c$) related to marginal cost.
Nationalisation

• Another possibility is to nationalise the industry and provide a subsidy to cover the loss
  – as was popular in Europe in 1945-80.
• If nationalised industries make losses, this does not prove they are failing to minimise costs or produce at the socially efficient output
  – but incentives may be a problem.

Reasons for nationalisation

• Natural monopoly
• Externalities
  – e.g. subsidising public transport (London Underground) may be a second-best option to road pricing
• Equity or distributional consequences
  – e.g. protecting transport in rural areas
• Co-ordinating a network
  – e.g. British Rail could have an overview of the whole rail system
Reasons for privatisation

- Improve incentives for production efficiency
  - makes managers accountable to shareholders.
  - but sheltered monopolies will be sleepy no matter who owns them
  - so privatisation will be most successful where there is potential for competition.
- Pre-commitment by government not to interfere for political reasons

Privatisation in practice

- At 1997 prices, almost £67billion was raised in revenue from privatisation in 1980-97.
- In terms of widening share ownership, effects were limited.
- The Private Finance Initiative (PFI) is claimed as an innovative way of drawing on private-sector expertise to finance and manage public projects such as roads and hospitals.
Regulation

• Privatisation does not remove the need for regulation.
• In the UK, regulation has been through price-capping
  – privatised industries are not permitted to raise prices beyond RPI-X
    • i.e. real prices must fall.
• Regulatory capture occurs when the regulating body comes to identify with the interests of the firm it regulates
  – eventually becoming its champion rather than its watchdog.