

# Finance as driver of privatisation

Jörg Huffschmid\*, PRESOM network<sup>•</sup>

## *Abstract*

The paper discusses the accumulation of private financial assets and the pressure on public budgets as powerful drivers of privatisation. Financial investors are the central actors in this process which develops in a framework of an increasingly finance-led capitalism. Financial investors are the main beneficiaries and strong promoters of the worldwide move towards privatisation of pension systems. With growing financial assets as a result of upwards income redistribution and pension reform traditional institutional investors have difficulties to generate attractive profits for their clients, and this calls for financial innovation. The activity of innovative financial investors has a double impact upon privatisation and upon privatised sectors: Private equity firms open up new areas for privatisation of public assets and services, and shareholder activism of hedge funds makes it increasingly difficult to fulfil public services obligations in privatised sectors. The EU does not counter but stimulates and supports these developments. To avoid further destabilisation and social polarisation social resistance and political intervention are necessary, in financial markets as well as in public services.

**Key words:** financial markets, financial investors, privatisation,

## **Introduction**

In this article financial markets and the strategies of traditional and particularly new actors on these markets are analysed as powerful drivers of the wave of privatisations especially during the current decade. While the links between privatisation and financial markets are usually discussed in a way which focuses on the impact of privatisation on financial markets – sometimes even regarding the former as a tool to develop the latter (see OECD 2003: 37) – we look at it from the opposite side: the impact of financial markets on privatisation. Both financial investment and privatisation experienced worldwide strong growth throughout the 1990s and reached a first peak at the end of the last century. With growing financial depth it becomes increasingly difficult to generate attractive profits through the strategies of traditional institutional investors (pension funds, insurance companies and mutual funds). This is then the time for financial innovators. Private equity (PE) firms expand to new areas of financial investment: non-quoted private firms or public services or assets. Hedge funds (HF) develop shareholder activism as new strategies. The business models of these innovators are in general focused on highly leveraged transactions and the generation of quick and large cash payments for the ultimate investors. This orientation will have contagion effects and impact the strategic behaviour of traditional private institutional investors and these contagious pressures will make it increasingly difficult to fulfil public service obligations or commitments which are often going along with the privatisation of formerly public services.

---

\* professor (em) for political economy and economic policy, University of Bremen

<sup>•</sup> This paper reflects part of the work and discussions of the working group on “privatisation and finance” in the framework of the European network “Privatisation and the European Social Model” (PRESOM) in which 16 partners from 12 EU member states work together. Responsibility for this text is of course with the author.

The article is organised as follows: In section 2 we present briefly the historical background and theoretical framework of the analysis: the enormous accumulation and internationalisation of private financial assets on the one hand, and, on the other hand, the increasing pressures on public budgets; they set the stage for privatisation which appears as serving both the interests of private asset holders and public authorities in an increasingly finance-led capitalism. The following section 3 deals with the specific role and strategies of financial investors, (institutional investors, private equity firms and hedge funds) in the process of privatisation and post-privatisation behaviour and with the problems these strategies generate. The EU agenda for financial markets and for public services will not control but rather accelerate these problems.(section 4) In the last section (5) the results are summarized and some preliminary deliberations about options and perspectives for political intervention to control financial markets and to safeguard and strengthen public services are presented.

## **Private wealth and public poverty – setting the stage for privatisation of public services**

### **Accumulation and internationalisation of private financial assets**

We start from the observation that there has been an extraordinary *growth of private financial assets* in the world over the last quarter of a century. As can be seen from figure 1 worldwide nominal Gross Domestic Product (GDP) in 2006 was 4,8 times higher than 26 years before, \$ 48,3 trillions after \$ 10,1 trillions. In contrast world financial stocks (WFS) had increased in 2006 to almost 14 times the amount of 1980, from \$ 12 to \$ 167 trillions. Whereas nominal GDP and WFS were of about the same size in 1980, by 2006 the latter had become three and a half times larger than the former.

#### ***Figure 1: Development of nominal GDP and financial stocks world-wide, 1980-2006***

Also the *internationalisation* of capital markets developed much faster than GDP and also than international trade (see figure 2)

#### ***Figure 2: Internationalisation of Financial Markets***

During the 1970s the amount of internationally invested financial assets corresponded to 50-70% of worldwide GDP, at the beginning of the current decade this ratio had risen to about 320%. This particular dynamic of internationalised financial assets also holds in comparison to international trade: the ratio was about 180% in 1970 and about 700% in 2004. (see: Lane et al. 2004 :35)

What were the background and driving forces for this extraordinary expansion and internationalisation of financial assets? Obviously internationalisation could not have happened without the shift of the regime of capital controls prevalent in the Bretton Woods world to a regime of *liberalisation of capital movements* since the mid-1970s. It is certainly also true that very extensive and generous *loan policies by banks* have played an accommodating role, particularly in the second half of the 1970s and during the last ten years. But the exclusiveness with which the International Monetary Fund (IMF) and the Bank for International Settlements (BIS) have stressed credit policies as the decisive reason of financial expansion and “excess liquidity” seems to be strongly exaggerated. It disregards two other factors – located outside

the financial system - which play a large and lastly decisive role for the extraordinary accumulation of private financial assets.

*Firstly*, the last 30 years have seen an almost continuous redistribution of income and wealth from the bottom to the top, clearly reflected in the falling wage share (see figure 4) in the three centres of contemporary capitalism. This has led, on the one hand, to a massive concentration of financial assets with a small group of individuals and firms and, on the other hand, to a slow-down in economic growth as a result of weak final demand.

***Figure 3: Background 1: Redistribution to the top***

*Secondly*, a further accumulation of financial claims took place in pension funds and insurance companies as a reflection of capital funded pension systems and the reform and partial privatisation of public PAYG-pension systems which were actively promoted since the 1980s by international financial institutions like OECD and World Bank. At the end of 2006, assets in pension funds (\$ 22,6 trillions) were almost five times higher than 1992 (\$ 4,8 trillions)

***Figure 4: Background 2: Financial assets in pension funds and insurance, 1992-2006***

**Excursion: The emergence of finance-led capitalism**

The extraordinary long-term accumulation of private financial assets which are not channelled back into the productive circuit<sup>1</sup> has started to change the relationship between the driving actors and bottlenecks of capitalist development towards a more finance driven dynamic. This can be visualised through figures 5a-5c.

***Figure 5a-5c: The changing role of financial markets: from finance for investments to financial investments***

In developing and traditional industrial capitalism the driving actors were *entrepreneurs* (or manager of firms) and finance was a bottleneck for corporate investment and economic development. (see figure 5a). This bottleneck was overcome not only through household saving but also and primarily through credit creation by the banking sector which was politically supported by the central banks. By contrast, in mature capitalist economies we have an abundance of financial assets for which profitable investment opportunities are becoming increasingly scarce (see figure 5b) - while at the same time credit creation continues at a large scale as the source of profits for the banking sector. Under these circumstances *financial investors* replace the *individual or corporate entrepreneur* as the leading actor in development. They collect and centralise large amounts of money and invest them in a broad range of activities of which production of goods and services is only one option. Capitalism becomes finance-led capitalism, at least in the developed centres. Privatisation is one prominent outlet for excessive capital (others are speculation, mergers and acquisitions, FDI et al.). (see figure 5c)

The long-term accumulation of financial assets which are to a large part not channelled back into the productive circle has been accompanied by weak economic growth. (see figure 6).

---

<sup>1</sup> This has also been observed by large international institutions like IMF and BIS. The fourth chapter of the Spring 2006 WEO is entitled "Awash with cash – Why are corporate savings so high?" and deals with this phenomenon, which puzzles the IMF.

**Figure 6: growth in the EU-15 and in the USA, 1960-2005**

As a result at least in the EU a vicious circle of low growth, rising unemployment and upwards redistribution can be observed (see figure 7) which fuels the strong growth of financial markets.

**Figure 7: Vicious circle: redistribution, slow growth, unemployment**

Profits and high incomes which are not used for investment or consumption are invested on the financial markets where they can temporarily boost economic growth through massive speculation. But when the speculative bubbles burst there will be massive negative effects upon growth, employment and the social welfare of the majority of people.

**Figure 8: Consequences of slow growth and redistribution – high growth of financial markets**

:

**Pressures upon public finance**

In contrast to the pressures of abundant private liquidity to find profitable investment opportunities we observe on the public side increasing pressure on budgets which force governments to cut public expenditures – and/or *to sell public assets and privatise public services*. Privatisation is regarded as a tool to soften – temporarily or permanently - these fiscal pressures.

Budgetary pressures are mainly resulting from two factors:

**Firstly, slow growth and high unemployment** lead to correspondingly low tax revenues and higher expenditure for social benefits. In the EU, slow growth is itself not the inevitable result from external factors but to a considerable degree due to a very restrictive macroeconomic policy.

- European *monetary policy* is only responsible for price stability and not for employment and growth – different for instance from the mission of the Federal Reserve system, for which highest possible employment belongs to the core tasks of the central bank. The ECB policy has been and is a barrier to stronger growth.

- *Fiscal policies* in the EU is restricted on the member countries level by the Stability and Growth Pact of 1997, obliging member states to attempts to bring public budgets in balance or surplus positions and imposing a maximum limit of 3% of GDP for public deficits. On the EU level, the European budget is so small (about 1% of EU GDP) that it cannot serve as an instrument to stabilize or to promote growth

**Secondly**, additional pressure on public budgets is coming from continuing *tax competition*. It is particularly strong for taxation of capital income (exemption of dividends of foreign investors from taxation, capital gains, interest income), high personal income (top rate reduction) and corporate taxation. With the accession of the Central and Eastern European new member countries (CEECs) in 2004 tax competition reached new momentum. From figure 9 it can be seen that since 1995 corporate tax rates have been reduced by 8,4 percentage points or almost one fifth in the old EU15, by 10,2 percentage points or one third in the new member countries. It can also be seen that whilst the general level of taxation has been substantially reduced, the competitive position between old and new member states has only marginally

changed: In 1995 the average rates in the CEECs were 7,3 pp lower than in EU15. In 2006 the difference had been 9,1 percentage points.

***Figure 9: Corporate tax rates in the EU, 1995-2006***

It must be conceded that at the same time during which tax rates have been sharply reduced tax bases have been broadened to a certain extent in many countries and to a certain extent set-off the loss of revenue resulting from rate reductions. But this extension of tax bases has limits and in any case tax competition takes place via “perceived” tax burdens which are determined by the tax rate.

**Privatisation: creation of investment opportunities and relief for public budgets**

In the framework of the emerging constellation of growing private financial assets seeking investment opportunities and growing pressures upon public finances privatisation appears as a solution to the problems of both the wealthy and the state: It gives the former a new area for investment and at the same time relaxes the financial burden for the latter. This is visualized in figure 10. Governments sell assets and service packages which they cannot longer afford to maintain because tax reduction for corporations and higher income brackets have diminished public revenue and the Stability and Growth Pact and corresponding national rules restrict severely public debt and deficits. But the same tax reductions have increased the net incomes of the beneficiaries at the top of the social pyramid. These use the additional money to buy from the government the assets and service undertakings. In a net calculation the whole procedure simply amounts to a gift to the top: Governments give money to rich individuals and then sell to them public assets for this money. Seen in terms of social substance the whole process is nothing else than the transformation of public to private wealth.

***Figure 10: Redistribution – Financial Markets - Privatization***

It remains an open question whether this privatisation of public services under fiscal pressures fulfils its purpose to reduce the fiscal burden for the state. This is obviously the case when together with the privatisation public responsibility for the maintenance of the previously public service is abandoned – with the accepted consequence of a deterioration in the quality, affordability, accessibility etc. of such services. In cases where government privatises services but maintains their provision as a public mission (organised via public regulation or PPPs) the costs of regulation or of buying or leasing facilities and services from the private sector will in a long-term perspective often be higher than public provision even if this must be financed through public loans.

**Private investors and privatisation**

More detailed figures than those which McKinsey has provided are available not for all \$167 trillions financial stock but only for private assets under management. The total amount of these assets reached about \$ 80 trillions at the end of 2006. More than three quarters (\$ 62 trns) were managed by institutional investors, one fifth was privately managed (by banks or endowments, foundations etc.) and 2% by “alternative” investments i.e. hedge funds and private equity. (IFSL 2007a: 6)

## Institutional Investors : Pension funds and privatisation of pension systems

Institutional investors are by far the most important traditional form of financial investors. In the last 26 years the assets under management by institutional investors rose from \$ 2,9 trillions in 1980 to 62 trillions in 2006, i.e. by a factor of 21. In the last four years assets under institutional or “conventional” management increased by \$ 26 trillions. They are now 50% higher than at the peak of the latest financial market boom.(figure 11)

**Figure 11: Global Fund Management of conventional assets**

Institutional Investors are subdivided in three large groups: investment (or mutual) funds, insurance and pension funds. The group with most funds is pension funds (\$ 23 trns.), followed by investment funds (\$ 22 trns.) and insurance (\$ 17 trns.). The structure of institutional investors differs strongly across countries: While in France only 3,5% and in Germany only 5,7 % of all conventionally managed funds are in pension funds, this category covers 60,6% of all institutional assets in the Netherlands, 49,2% in the USA and 34,1% in the UK. In Germany more than three quarters of assets (77,5%) are managed by insurance companies, which in the USA account only for less than one fifth (18,6%). (see table 1).

**Table 1: Sources of global assets under conventional management, end 2006**

	Pension funds		Insurance assets		Mutual funds		Total		
	trn.\$	%	trn. \$	%	trns. \$	%	trn.\$	%	% of total
US	15,893	49,2	6,012	18,6	10,414	32,2	32,319	100	52,3
Japan	1,16	27,4	2,49	58,9	0,579	13,7	4,229	100	6,8
UK	1,686	34,1	2,469	50,0	0,787	15,9	4,942	100	8,0
France	0,133	3,5	1,863	49,5	1,769	47,0	3,765	100	6,1
Germany	0,116	5,7	1,571	77,5	0,34	16,8	2,027	100	3,3
Netherlands	0,827	60,6	0,428	31,4	0,109	8,0	1,364	100	2,2
Switzerland	0,456	46,3	0,368	37,4	0,16	16,2	0,985	100	1,6
Other	2,376	19,5	2,19	18,0	7,607	62,5	12,174	100	19,7
<b>Total</b>	<b>22,648</b>	<b>36,6</b>	<b>17,392</b>	<b>28,1</b>	<b>21,765</b>	<b>35,2</b>	<b>61,804</b>	<b>100</b>	<b>100</b>

source: IFSL 2007b: 6

The industry is rather concentrated: The four largest firms have each more than \$ 1 trillion under management and the ten largest manage 17% of total funds. (see table 2)

**Table 2: Largest global investment managers**

Nr.	Name	Country	assets
1	Barclays Global Investors	UK	1 623
2	State Street Global Advisers	US	1 534
3	Fidelity Investments	US	1 300
4	The Vanguard Group	US	1 050
5	JP Morgan Asset Management	US	898
6	Capital Res. And Management	US	850
7	ING Investment Management	NL	694
8	Deutsche Asset Management	DE	662
9	UBS Global Asset Management	CH	658
10	Credit Agricole Asset Management	FR	642
11	PIMCO Allianz Global Investment	DE	642
12	Northern Trust Global Investors	US	640
13	AllianceBernstein L.P.	US	625

14	Axa Investment Managers	FR	579
15	Prudential Investment Management	US	568

Source: IFSL 2007b: 6

The largest group of institutional investors, pension funds, is directly linked to the structure and changes in pension systems. While in a few countries like the US and the UK pension systems have traditionally been based mostly on private capital stocks, most other countries have seen strong efforts for pension reforms with the aim to complement or substitute the traditional public PAYG pension systems through private capital funded systems. This thrust for the (at least partial) privatisation of public pension systems is a worldwide phenomenon, starting already in the 1970s in Latin America (the first changes took place in Chile immediately after the coup d'état of general Pinochet in 1973). It received a further strong push and support through international financial institutions like World Bank and OECD and reached continental Europe – East and West – in the 1990s. The strong growth of pension funds during the last decade cannot be explained by the development of the traditionally private systems - the comparatively slow macroeconomic growth, even slower wage development and high unemployment had also a moderating effect on the development of individual contributions to pension funds – but they are the result of the privatisation of increasing parts of pension systems. This has been in the interest of pension funds (and of insurance companies), which are – in Europe more than in the US - in many cases managed by off-springs of large financial corporations like Barclays, ING, Allianz, Axa, Deutsche Bank, UBS etc.

The theoretical and political justification for a shift from public PAYG to private capital funded systems has been the ongoing demographic change towards societies with a larger part of elder (i.e. retired) persons. These changes allegedly make it impossible to maintain the traditional systems and require additional individual savings. By now it has been shown that such arguments are untenable (see e.g. Baker/Weisbrot 2000, Eatwell 2003, Richard Minns 2001) and that the increase of the share of elderly persons in the population requires – if their relative living standard is to be maintained – a larger share of goods and services produced at the time of their retirement, regardless of how this is organised – through rising contributions of the active part of the population or through more individual savings by the pensioners before their retirement. Comparisons between the two – theoretically equivalent – systems have shown that capital funded systems are less reliable, less comprehensive and much more expensive than PAYG systems. If in spite of these facts the propaganda and thrust for further privatisation of pension systems continues, this is a strong indicator not only for the interests of the benefiting financial investors but also for their power to impose this interest upon society.

Institutional investors have been developing steadily during the last 25 years and their assets have massively increased during the last years. This increase has made it more difficult for them to generate the attractive returns which they need to keep their customers (the ultimate money-owners) and maintain or enhance their competitive position in the markets. These difficulties have generated and created space for various financial innovations and innovators, which have started to change the reach and impact of financial investors, with considerable consequences for the thrust for privatisation – and for the implementation of public service obligations in privatised services. Most prominently amongst those financial innovators are private equity firms who open up *new areas* for financial investment and hedge funds who introduce *new strategies* and benchmarks in corporate governance.

### **Private equity and privatisation**

*Private equity firms* (PEF) are undertakings who collect money from banks, pension funds and “High net worth individuals” (HNWI), borrow additional resources from banks, use the money to buy firms, restructure them and sell them with high profits either on the stock exchange, or to strategic investors or to other PE firms. (see figure 12)

**Figure 12: Private equity: How it works**

Worldwide PE investment developed in an unsteady way during the last 10 years: it rose steadily from \$ 60 billions. in 1996 to \$ 200 in 2000, then dropped sharply to less than \$ 100 billions. in 2002, and picked up slowly from 2002 to 2005. In 2006 it virtually exploded and reached \$ 365 billions., this is three times the value of 2005. In the first half of 2007 the strong growth continued before the sharp cut-back as a result of the financial crisis.

The extraordinary rise of PE investment in 2006 is partly due to the fact that that year saw a number of mega-deals which have until then been rather the exception. Of the 10 largest transactions since the end of the 1980s seven were carried out in 2006 or 2007 (see IFSL 2007a: 4). Although the large majority of PE firms is of US origin (see figure 20) Europe is catching up, rapidly in terms of funds raised (where the European share rose from 21% in 2000 to 44% of funds raised worldwide in 2006), not so rapidly in terms of investment (increase from 21% to 24%). (see IFSL 2007: 2)

Private equity activities are involved in the privatisation of public assets and services in different ways: The most important of these is the direct acquisition of public assets or corporations with the purpose to restructure and sell them after some years. In addition to this PEF sometimes buy privatised firms or parts thereof from the firm which originally bought the public asset or service unit from the state and later wants to resell it or outsource certain parts of it.

*Direct privatisation activities.* Until the beginning of the current decade private equity funds were not particularly active on the buyer side of privatisations. Reasons for their reluctance were amongst others “government scepticism towards privatisation” and “regulatory constraints imposed in many privatisations”. This is particularly true for the privatisation of large state-owned corporations in tariff-regulated industries or in “sectors with stringent employment level constraints” (like utilities or former municipalities). (Levantini: 20/21). Such regulations and constraints were seen as an obstacle against thorough restructuring.

The beginning of PE engagement in privatisations was therefore more on the local and regional levels where no such regulations existed or, when they existed, it was more difficult to enforce them. A favourite sector in this respect is *public housing*. Many municipalities and regional governments, which were often under even stronger fiscal pressures than the central government sold part of their stock in public residences, and PEF were prominent on the buyer side.

A good example is Germany, with 40 million units the largest market for residential real estate in Europe, and the market with the lowest share (43%) of private residential property (Spain 87%, UK 70%, France 57%). PEF have bought about 650 000 residences for €30 billions since 2000. Amongst the most prominent transactions were sales by municipalities like Dresden or Berlin, public social agencies like Gagfah (the public pension insurance organisation for employees) and state-owned banks like HSH Bank or Norddeutsche Landesbank.(see table 3) In October 2006 the government of Nordrhein-Westfalen decided to privatise all of

the 96 000 residences which it owns, hoping hereby to raise between 3 and 4 billions of euros. This decision has attracted the active interest of various PEF like Apax, Blackstone, KKR and Permira. The procedure is still pending and is met with strong criticism and resistance from tenants and local groups and trade unions.

**Table 3: PEF activity in residential privatisations in Germany since 2003**

Year	Company	units	buyer	price
2003	HSH Bank	10 000	Deutsche Annington	
2003	Bavaria Objekt und Baubetreuung	3 500	Cerberus	
2004	GSW (Land Berlin)	65 700	Cerberus/Goldman Sachs	2,1
2004	Bundesversicherungsanstalt für Angestellte (GAGFAH)	82 000	Fortress	3,5
2005	GHG Wohnen GmbH (Berliner Verkehrsbetriebe)	5100	Corpus	0,4
2005	Nileg (Norddeutsche Landesbank)	28 500	Fortress	1,5
2005	GEHAG (HSH Nordbank)	18 000	Oaktree	1,0
2005	LEG Landesentwicklungsgesellschaft Nordrhein Westfalen	4 300		
2006	Woba Dresden	48 000	Fortress	1,7
2008 planned	LEG (Landesentwicklungsgesellschaft Nordrhein-Westfalen)	100 000	Apax, Blackstone, KKR, Permira	2,5

Source: DB Research no.321 (May 2005), KPMG Institut für den öffentlichen Sektor e.V., Wohnungswirtschaft

In 2006 private equity activity in large European privatisations peaked: In five out of 59 large transactions with a total value of €40,4 billion PEF were on the buyers side, paying a total amount of €10,4 billions, i.e. 25% of all privatisation revenues (see table 4).

**Table 4 : PEF in privatisations in 2006**

country	Company	% sold	Price €bn	buyer
Germany	Deutsche Telecom	4,5	2,68	Blackstone
	Woba Dresden	100	1,63	Fortress
	HSH Nordbank	24,1	1,27	Christopher Flowers
France	Pages Jaunes (France Télécom)	54,0	3,31	KKR
Netherlands	AVR Bedrijven (city of Rotterdam)	100	1,41	CVC Capital Partners
Total			10,3	

Source privatisation barometer Newsletters Nos 5 and 6

*Post-privatisation and infrastructure activities.* PEF can recently also be found as investors in (public) infrastructure like water, electricity, waste management. (see Hall 2006) also airports, motorways and postal services. What is remarkable here is that only in relatively few

cases of privatisation of infrastructure PEF are the original buyers from the state – like CVC which in 2005 bought 25% of Post Denmark and 50% of Belgian Post or the Australian Macquarie which bought 80% of the Swedish Airport.(Hall: 16) In many other - and indeed in the majority of – cases PEF appear as *second buyers* of companies or parts thereof which were previously privatised and sold by governments to strategic investors. Important examples of such “secondary market activities” in privatised sectors are water, waste management and energy (see Hall 2006: 14-16). For instance the German energy corporation RWE bought most of the privatised British Water Corporations throughout the 1990s, as a part of transforming RWE into an “integrated utilities complex” When this strategy failed water and waste management firms were sold – and on the buyers side were mostly PEF. In this context it seems that some PEF have adopted – at least for their infrastructure funds – a business model which differs from the original PE perspective. Instead of trying to sell the firm after a relatively short period of restructuring they “expect long-term steady returns, and so are less likely to seek short-term ‘exit’ by selling the company.”(Hall:7)

### **Hedge Funds and public service obligation in privatised companies**

*Hedge funds* (HF) are assets which come from HNWI and banks, and increasingly also from institutional investors (particularly pension funds) and which are invested by the HF managers in high profit - high risk securities (*financial speculation*) or in quoted stocks where they develop *shareholder activism* to generate high dividend payments or to enhance market capitalisation or to boost takeover prices.(see figure 13) This second leg of their strategy is relatively new. It is estimated that currently there are about 9000 HF managing about \$ 1,5 trillions of private money. (see IFSL 2007: 1) This figure appears peanuts in comparison to the \$ 62 trillions managed by “traditional” institutional investors. But it should be kept in mind that HF operate on a highly leveraged basis and with \$ 1,5 trillions private capital can invest about ten times this amount, i.e. about \$ 15 trillions, which is then much less peanuts and much more coconut.

#### ***Figure 13: Hedge Funds: How it works***

The majority of hedge fund assets is still of US origin. However the US share declined from more than four fifths (82%) to just under two thirds (65%) between 2002 and 2006. Europe is rapidly catching up, with an increase of its hedge funds asset share from 12% to 24% during these four years. The role of Asia as a region of origin of hedge fund assets has also risen from 5% to 8%, but remains low.(See *ibid.*: 2) More than half of all hedge funds (55%) worldwide have their legal domicile offshore (mostly on the Cayman Islands) and of those domiciled onshore about half (48%) is registered in the US (mostly in Delaware) (see *ibid.*: 7).

While the traditional strategy of HF, financial speculation, contributes to financial instability<sup>2</sup>, it is not directly relevant for the issue of privatisation, the second strategy, shareholder activism, plays an important role in the context of privatisation, not so much through the direct acquisition of privatised firms or services as through the impact they exert on the management of large corporations, privatised or not. The direction of this pressure is clear: it aims at rapid and large cash-flows for the shareholders, not at the long-term strategic position and performance of the firm.

---

<sup>2</sup> A recent example for this is the fact that HFs were prominent amongst the (highly leveraged) buyers of loan packages from the special purpose vehicles or conduits to which the banks had sold these loans. Thus they contributed to the worldwide contagion of the relatively modest sub-prime crisis in the US.

The problems of this business orientation do not only pertain to the firms immediately affected through HF pressure. At least as important and on the whole much more dangerous is the threat of *systemic contagion*. It is the proliferation of the aggressive strategies of PE and HF to traditional institutional investors which are the main pillars of financial investment or the management of financial assets. Hedge funds establish standards and benchmarks which other financial investors must also fulfil in order to stay in the market. Particularly alarming is the fact that the share of assets which pension funds have invested in HF to raise their returns has more than doubled during the last decade, from 5 to 11%. (see figure 14), thus, on the one hand, exposing the pensions of employees increasingly to the risks of financial markets and exerting, on the other hand, increasing pressure on these employees to work more for less money and on the state to cut social expenditure.

***Figure 14: Global hedge funds by source of capital***

The mechanism of contagion is based on the fact that institutional investors are private firms which compete for the money of their clients as ultimate asset owners. A pension fund which has invested the employees pension contributions in a stock company with a long term perspective sees the profits (and its own earnings) rise when one or more HF invest in the same company and force the management to generate and distribute more short-term cash-flow to the shareholders. The pension fund as one of these shareholders benefits from this aggressive HF strategy although it did not apply it itself. Higher returns for this PF exert pressure on all other institutional investors to generate equally large and quick cash flows. So the initial limited measure in one company is imposed as general benchmark upon all institutional investors. This process has started and is getting momentum in Europe.

This has severe consequences for the management of privatised firms and services. In large privatised sectors like utilities and telecom it will become increasingly difficult to fulfil the universal service obligations under the pressure of HF and institutional investors to maximise short-term returns. The balance between high profits and public service commitment – which regulatory authorities try to maintain – will be heavily shifted towards the profit side. And if regulation were successful to prevent this by strict intervention shareholders will quit and market capitalisation will dramatically fall. In such an emergency case it will certainly be in the first place the employees who have to pay the price for keeping the company in business. The conception that high service quality and high profits in network industries can permanently coexist – i.e. the core rationale for privatisation of public network services – will be undermined and destroyed under the enhanced pressure of a new generation of financial investors to generate maximum profits in minimum time.

## **The European agenda: More market-opening and deregulation**

The current agendas of the EU for financial markets and for public services do not take account of the new problems which arise with stronger activities of PE and HF for the provision of efficient, universal and affordable public services, when their provision is outsourced to private investors. Instead of stronger control and enforcement of public services commitments the scene is set for more deregulation, competition and market-opening in both areas.

In the area of *financial markets* the Commission focuses on stronger market opening and deregulation. Particularly two developments are remarkable:

- On the basis of a report on “*Special rights of public authorities in privatised EU companies: the microeconomic impact*” (Oxera 2005) the Commission has recently brought to the European Court of Justice (ECJ) an increasing number of cases for infringement of the open market for capital rule and therefore breach of the ECT. The recent ruling against the German VW is the most spectacular but not the only case in this direction.

- In a recent *White paper on Enhancing the Single Market Framework for Investment Funds* (European Commission 2006d:13) the Commission declares its intention to “examine the types of marketing and sales restrictions that should be removed in the context of the shift to conduct of business rules at the level of the investment firm...” In this respect it seems to follow the recommendations of two reports of expert groups on HF and PE (see European Commission 2006a and 2006b) which were published in July 2006. Remarkably these expert groups who were appointed by the Commission consisted exclusively of representatives of financial institutions as if these were the only ones affected by the organisation of HF and PE. Not surprisingly they recommended a further liberalisation of the markets. Particularly they advocate the removal of the modest national limits for investment of institutional investors in risky asset classes (like HF and PE) “which entail relatively high probability of very adverse investment outcomes” (European Commission 2006d:13.). With this it reinforced the deregulatory approach in the Market in Financial Instruments Directive (MiFID) of 2004,(in force since November 2007) which “replaces crude restrictions on the sale of certain instruments to certain categories of investors with a system which places responsibility on the investment firm to ascertain, on a client-by-client basis, whether a particular investment is suitable or appropriate.”(ibid.) .

The prohibition of such national barriers could and most probably would trigger a new stream of investment from pension funds in PE and HF.

For *public services* the discussion about the Green paper (European Commission 2003) and White paper (European Commission 2004) of services of general interest, about art. 16 of the ECT and about the Services directive have resulted in the formation of an – in spite of all rhetorical concessions - alarmingly neo-liberal position on the side of the Commission.. It is developed via, on the one hand, the overarching importance of the competition rules in the Treaty, and, on the other hand, the definition of an economic activity. The clearest example of this position can be seen in the case of *social services*. After these had been taken out of the Services Directives in spring 2006 the Commission announced and recently published a communication on social services, the thrust of which is identical with that of the Services Directive.(Commission 2006c) The decisive point is, that if a service is provided for money – regardless of the appropriateness of the price and of the ultimate source of finance – it is regarded as an economic activity and must be subordinated to the competition rules. In other words: An entity providing a public service (health, education) against money has to behave as if it were a private firm in a private market. With remarkable frankness the Commission concludes “It therefore follows that almost all services offered in the social field can be considered “economic activities” within the meaning of articles 43 and 49 of the EC treaty.”(ibid: 9) It seems logical that if social services have to be provided under conditions of open markets and competition there is no reason why they should not be privatised.

If these points of the EU agenda were carried out the likely result would be, on the one hand, more pressure for privatisation in hitherto largely publicly provided social services (e.g. in healthcare and education), and, on the other hand more shareholder oriented pressures on institutional investors in privatised firms as a result of enhanced PE and HF activity.

## Summary and outlook for reforms

In this paper privatisation was regarded as a response to the development of private and public finance. It is on the one hand the result of increasing pressure from financial investors. These are the main actors in the emerging finance-led capitalism and their role is the discovery and development of investment opportunities for the extraordinarily growing amounts of private financial assets. On the other hand public finance gets under pressure through slow growth, high unemployment and strong tax competition. Privatisation appears as a solution of the problems of both, private wealth and public poverty. While the participation of traditional institutional investors in the privatisation of large public corporations and their role in the shifting from public PAYG to private capital funded pension systems is not a new phenomenon, the developments after the financial boom and crash at the end of the last decade have led to financial innovations, which on the one hand, via PEF, expands the range of privatisation of public assets into social housing, public infrastructure and other public services, and, on the other hand, via HF enforce a stronger shareholder value orientation upon privatised corporations and therefore undermine the fulfilment of public service obligations in privatised sectors and corporations. Both contribute to the destabilisation of the financial system and of the economy at large, and both reinforces the thrust of the ongoing neo-liberal counter-reform and to further social inequality and tensions.

Against this role of financial investors as drivers of further privatisation and threats to public service requirements political action is required.

On the level of *financial markets* the harmful effects of HF and PE strategies could be contained through

- requirement of more information and transparency
- restriction on leverage, because high leverage includes, on the one hand, additional indebtedness for the firms which PE buys, and, on the other hand, enhanced systemic risk for financial stability in case of a single default.
- for PE: prohibition of special dividends, bonuses or other form of capital withdrawals in the first years after the purchase of a firm
- for HF: to fight short-termism and hit-and-run policies by hedge funds it could be helpful to adopt a rule that voting rights begin only after a minimum holding period (e.g. one year).
- for pension funds and insurance corporations: investment in PE and HF should be prohibited in order to avoid incalculable risks for future incomes of pensioners.
- for banks: securitisation and resale of loans should be severely constrained or forbidden because they are in the last instance a way of circumventing the capital requirement rules.

On the level of *services of general interest (public services)* the Commission's extremely extensive conception of "economic activity" and of the dominant role of competition in the economy are unacceptable as a limiting framework for the conceptualisation of public services. Nor is it the only and necessary conclusion from the text of the Treaty. The formal option of member states to declare certain – particularly social – services as public goods has no political relevance if at the same time any economic activity is excluded from this definition. It is privatisation through the backdoor. The opposite approach would be reasonable: Once a sector or a service has been declared by a member state as of "general interest" it would no longer fall under the governance of the competition rules – regardless of the form in which the services are provided, as economic activity or not. For such cases it is of course necessary to develop principles and tools for the democratic and efficient management of such sectors, including their financing through regular tax revenues.

Finally, if under the pressure of more aggressive financial investors it becomes increasingly difficult – and costly – to monitor and enforce public service obligations in privatised sectors a re-nationalisation (or re-municipalisation) could be the most efficient, the cheapest and the most democratic remedy.

## References

- Baker, Dean and Mark Weisbrot (2000) *Social Security: the Phoney Crisis*, Chicago
- Eatwell, John (2003) *The Anatomy of the Pension “Crisis” and Three Fallacies on Pensions*, European Commission (2003), *Green Paper on services of general interest*, COM(2003) 270 final, 21 May, 2003 Brussels
- European Commission (2004) *White Paper on services of general interest*, COM(2004)374 final, Brussels
- European Commission (2006a) *Report of the Alternative Investment Expert Group, Managing, Servicing and Marketing Hedge Funds in Europe*, Brussels
- European Commission (2006b) *Report of the Alternative Investment Expert Group, Developing European Private Equity*, Brussels
- European Commission (2006c) *Implementing the Community Lisbon Programme. Social services of general interest in the European Union*, Brussels
- European Commission (2006d) *White paper on Enhancing the Single Market Framework for Investment Funds*, COM(2006) 686 final, 15 November 2006, Brussels
- Farrell, Diana, Christian S. Fölster, and Susan Lund (2008), *Long-term trends in the global capital markets*, The McKinsey Quarterly, Economic Studies, February,
- Hall, David (2006), *Private equity and infrastructure funds in public services and utilities*, PSIRU ([www.psiru.org](http://www.psiru.org))
- Hall, David (2007), EU fiscal rules and PPPs. Discussion note for PRESOM meeting, Berlin
- IFSL (2007) *Hedge Funds*, City Business Series, April ([www.ifsl.org.uk](http://www.ifsl.org.uk))
- IFSL (2007a) *Private Equity 2007*, IFSL Research, London, August ([www.ifsl.org.uk](http://www.ifsl.org.uk))
- IFSL (2007b) *Fund Management 2007*, IFSL Research, London, September ([www.ifsl.org.uk](http://www.ifsl.org.uk))
- International Monetary Funds (2006), *World Economic Outlook*, Spring 2006, Washington D.,C. ([www.imf.int](http://www.imf.int))
- Levantini, Andrea (2007), *The Role of Private Equity Funds in Global Privatizations*, in: Privatization Barometer Newsletter No. 6. January 2007 ([www.privatizationbarometer.net](http://www.privatizationbarometer.net))
- Lane, Philip R., Gian Maria Milesi-Ferretti ((2006) *The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970-2004*, IMF Working Paper WP/06/69, Washington
- Minns, Richard (2001) *The Cold War in Welfare: Stock Markets versus Pensions*, London
- OECD (2003) *Privatising State-owned Enterprise. An overview of policies and practices in OED countries*, Paris
- OECD (2001) *Institutional Investors, 1980-2001*, CD-Rom
- Oxera (2005) *Special rights of public authorities in privatised EU companies: the microeconomic impact*, London, [http://ec.europa.eu/internal\\_market/capital/docs/2005\\_10\\_special\\_rights\\_executive\\_summary\\_en.pdf](http://ec.europa.eu/internal_market/capital/docs/2005_10_special_rights_executive_summary_en.pdf))