# Why do governments nationalize failing businesses at the tax payer's expense?

Stephen Ricca


## Abstract:

Governments and businesses do not make the same decisions as each other, as their priorities and responsibilities differ from one another. This in turn then exposes certain shortfalls that may happen in the business sector and in turn means it is suitable for the government to intervene. Prestwick airport has been used as an example of a recent business to be nationalized, and the reasons that the Scottish government nationalized the airport have been looked at in comparison to why the airport was not bought by a private buyer.


For use with Mochrie, *Intermediate Microeconomics,* Palgrave 2016

In March 2012 the owners of Prestwick airport, Infratel, announced they were looking for buyers for the airport as they were running annual losses of £2 million.[1] Upon failing to find prospective buyers, Infratel announced that they would look at plans to close the airport. After this announcement came the news that the Scottish government now plan to nationalize the transport hub.[2] This is where I will discuss why the government will buy a failing airport when no private company will.

If the government will buy a business that no private buyer wants, it implies that perhaps governments and private buyers have a different view when deciding to buy a business. I will look at the different ways in which businesses and governments look at costs, and the timeframes which they look at in terms of investment and profitability. One thing businesses look at to help cut costs is the economic shutdown price, below which it will produce no output[3]. It is the point where marginal costs and average variable costs meet. Anything below this point shows a business is no longer covering their variable costs, so therefore to save money should shutdown.[4] Although a simplistic approach, it's especially useful for seasonal industries to use, such as ski resorts, as they will have peaks in revenue during winter periods and declining business when the snow melts, so they should use the shutdown rule to decide if and when to shut down.

However, any government owned businesses would tend to apply this rule very differently or not use it at all. The reason for this is that governments would look at costs in a very different way and this model is just too simplistic for a government to use. Consider a simple business model with just one fixed and one variable cost - Labour being variable and rent being fixed. A normal private owned business would shut down if they stopped covering labour cost. However under public ownership the government would look at it differently as they would account for externalities in cost as well. These include many different factors which in the government's eyes, increase the real cost of "shutdown" much beyond the point a private business would have to consider.

At Prestwick we can assume that it would have been desirable for the owners to shut down temporarily during quiet times in order to minimise losses. However this is the type of business in which the shutdown rule has limitations as an airport cannot shut during quiet months. They have a responsibility to the airlines who have contracts with the airport, as well as a reputation that can't be lost. This is why if Prestwick's owners were considering closure, we can see that it

[1] (BBC NEWS, 2013)
[2] (Carrell, 2013)
[3] (Varian, 2010)
[4] (CHRYSTAL, 2007)

was because in the long run it was loss making and in economics all businesses need to cover costs in the long run.[5]

This then brings us onto the government: why would they look to buy the loss-making airport which has no view of turning back to profitability overnight? This is where real government costs need to be analysed more closely. Businesses are generally more focused on accounting profits (Profit = Revenue - Costs), rather than economic profit which includes opportunity cost also. However, governments do not look at this in such a simple way as their responsibilities lie outside an individual business. Governments need to take into account any externalities which this airport has. There are 1400 jobs tied to this airport[6], and each in turn making an income tax contribution. In the UK the average contribution is 4,398 per year[7] so this equates to £6,517,200. If the airport were to close, it would create unemployment, and the government would lose out on millions alone from income tax. If they lose out on this we can assume that these people will then have a period of unemployment, where they will then claim jobseekers allowance, this is 71.70 per week for over 25s[8] which is extra cost to the government.

Governments also are aware of the negative impact a closure of business will have on surrounding communities, something which businesses do not really look at. Whole communities may depend on the airport as their main source of income, both through direct employment through it, and the economic multiplier effect which takes place in an economy. The multiplier shows that for every pound earned in an economy, it will create X number of more pounds depending on the marginal propensity to consume, which is the ratio to which people spend and in relation to their income. Let’s assume the MPC is 0.8, the multiplier is given by equation 1/1-mpc we can see that for every £1 earned in an economy, it actually creates an extra £5 in the economy.[9] The multiplier effect is something that is largely ignored by privately owned businesses as they are not affected by externalities in the same way, but we can see why governments look at these when calculating the real cost of a company shutting down.

The multiplier effect can be understood from the following. Employees of the Prestwick airport would spend their money in pubs and shops in the area, all creating a supply of jobs. If the airport were to close, it is not only the people of the airport who lose their jobs, but it would

[5] (Varian, 2010)
[6] (Carrell, 2013)
[7] (ROBINSON, 2013)
[8] (Crown, 2013)
[9] (Economics Online, n.d.)

have a much wider negative effect on jobs in the surrounding community too creating a devastating trail of negative externalities which the government would have to pay for.

Any announcement for nationalisation usually comes with much criticism. Many people were unhappy that it would be taxpayers' money paying for the shortfall of Prestwick. This is not entirely true however. Prestwick airport creates millions of pounds' worth of revenue for the government each year itself. This alone offsets the loss that it is making, so therefore this airport is not actually a loss-making airport in the hands of the government, as for what it makes shortfalls on in accounting terms on paper, it still generates millions of pounds of tax, as well as supports many other jobs and families in the area. The government sees the airport as an investment[10], but in an entirely different view from what a business would see it. A business invests to make money; however a government has a responsibility to create jobs for people. Upon failing to create jobs, the government has the responsibility to provide welfare for people. If the airport were to close, this would mean that 1400 people would be out of employment and would start claiming benefits, something that the government looks at in terms of costs. The government is investing in this airport to secure the long term provision of jobs at this site, and to return it back to profitability to then de-nationalize again.

When we look at what a business considers when making financial decisions, it's apparent that it is very different to what the government must consider, and indeed much simpler. A business does not care in the same way if its closure will have a negative impact on surrounding jobs, as their responsibility is to the shareholders, and ends on the fences of their site. Although most moral managers will look at other options before closure, it's evident that incentives to stay open are far greater for governments than private firms, as beyond the fence lies merely a moral obligation for firms, whereas the financial obligation lies countrywide for the government, and this is why the government invests in nationalising certain industries.

[10] (BBC NEWS, 2013)

## Bibliography:


BBC NEWS, 2013. *BBC NEWS.* [Online]
Available at: http://www.bbc.co.uk/news/uk-scotland-scotland-business-24446591
[Accessed 4th November 2013].

BBC NEWS, 2013. *BBC NEWS.* [Online]
Available at: http://www.bbc.co.uk/news/uk-scotland-scotland-politics-24456708
[Accessed 5th November 2013].

Carrell, S., 2013. *TheGuardian.* [Online]
Available at: http://www.theguardian.com/uk-news/2013/oct/08/prestwick-airport-nationalised-scotland
[Accessed 04 November 2013].

CHRYSTAL, L., 2007. *ECONOMICS.* New York: OXFORD UNIVERSITY PRESS.

Crown, 2013. *GOV.UK.* [Online]
Available at: https://www.gov.uk/jobseekers-allowance/what-youll-get
[Accessed 4th Novermber 2013].

Economics Online, n.d. *The multiplier effect.* [Online]
Available at:
http://www.economicsonline.co.uk/Managing_the_economy/The_multiplier_effect.html
[Accessed 4th November 2013].

ROBINSON, M., 2013. *Daily Mail.* [Online]
Available at: http://www.dailymail.co.uk/news/article-2327394/Elmbridge-The-Surrey-borough-pays-1-18BILLION-income-tax.html
[Accessed 04 November 2013].

Varian, H., 2010. *Intermediate Microeconomics.* 8th ed. New York: W.W. Norton & Company.