Removing rail subsidies could end up benefiting passengers

Taxpayer subsidies to the rail sector have increased dramatically in recent years, with concomitant fare increases attracting widespread condemnation. **Richard Wellings** *argues that structural reform to the railways is necessary to reduce the burden on the public purse.*

Taxpayer subsidies to the rail sector have reached astronomical levels. At £6 billion per year (including Crossrail), they have roughly trebled in real terms over the last twenty years. But the high rate of subsidy has not led to a reduction in fares, which have risen above the official rate of inflation in recent years. There are two main reasons for the large increase in taxpayer support. The first, and probably most important, is wasteful investment in loss-making new infrastructure. This is the direct result of policies that have aimed to increase public transport ridership and reduce car use.

For much of the post-war period, rail was viewed as a declining industry. Despite previous government efforts to suppress private road transport, the step change in efficiency resulting from the door-to-door transit of passengers and freight led to rapid growth in car and lorry traffic. A policy of 'managed decline' was therefore applied to the railways. British Rail received subsidies to keep the system going and there was some modernisation of key inter-city routes, but there was little enthusiasm to attempt to reverse the long-term trend.

This changed with the ascendancy of environmentalism within government. With their perspective grounded in radical egalitarianism, environmentalists not only objected to the pollution produced by private road transport; they also resented its social aspects – for example, the way that cars had become symbols of wealth and individual expression. The environmentalist agenda gradually captured university departments, various government bureaucracies, elements of the media and eventually national policy. In the mid-late 1990s, the road construction programme was cut back dramatically and a new strategy introduced. Private road transport would be deliberately discouraged with travellers encouraged to use buses, trams and trains instead.

For the railways this represented a sea change. The new policy meant that rail now had prospects for growth. It did not, however, change the fundamental economics. Since rail involves at least a three-stage journey, compared to the door-to-door convenience of private road transport, it remained unattractive for the vast majority of journeys.

Following privatisation, however, the policy of encouraging more rail travel appeared to be successful. Usage rose by around 50 per cent between 1997 and 2012, to levels not seen in peacetime since the 1920s. This reflected not just the impact of various deliberate policies, but also other trends such as a booming central London economy for much of the period and demographic changes that led to a huge expansion of the 'inner city', pushing middle-class families out into the commuter belt to avoid poor schools, anti-social behaviour and fear of crime.

A combination of increased ridership and price controls produced severe peak-time overcrowding on several routes into London. Train operating companies have been constrained in their ability to smooth the peaks using the price mechanism, since season ticket fares on most London commuter journeys are regulated by the government. With a severely limited ability to deploy the price mechanism and other means to make more efficient use of existing rail capacity, the industry has increasingly focused on supplying new infrastructure to accommodate growth. This has proved hugely expensive, however. The final cost of the ongoing Thameslink 2000 upgrade, for example, is likely to be £6 billion. And the Crossrail scheme will cost £16 billion.

Since in commercial terms such projects are loss-making and would never be undertaken in their current form by the private sector, taxpayers have been forced to fund them. Accordingly, wasteful investment in new rail infrastructure is probably the largest single factor in the growth in taxpayer support in the post-privatisation era. Such investment has not been restricted to overcrowded routes in the South-East. The government also funds improvements for blatantly political reasons, in regions where there is little passenger demand. For example, it was recently announced that branch lines in South Wales would be electrified – at taxpayers' expense, of course. The environmentalist agenda means that rail schemes get priority even though the government's own cost-benefit analyses show that economic returns from road improvements are far higher.

The second major reason for the increased burden on taxpayers is the artificial structure imposed by the government on the post-privatisation rail industry. Historically, railways that developed in the private sector exhibited a high degree of vertical integration. This meant in practice that the same company owned the tracks and operated the trains, thereby avoiding the transaction costs associated with complex contractual arrangements between highly interdependent separate organisations.

Partly as a result of EU policy, Britain's privatisation model has been very different, with one firm owning and maintaining the tracks, other firms operating the trains, and another set of firms leasing out the rolling stock. On top of all this complexity, the industry has been tightly regulated by various government agencies. The resulting fragmentation, combined with layers of bureaucracy, needlessly increased costs on the network. In addition, the high levels of regulation severely hindered entrepreneurship. As a result, the productivity-boosting innovations that have cut costs in other industries did not materialise on the railways. Indeed regulation is now so restrictive that private rail firms have effectively become subcontractors for the Department for Transport.

Structural reform would therefore be one of the best ways to reduce the burden on taxpayers. The government should stop prescribing the level of vertical integration and instead free the rail industry to become more efficient. This policy should be combined with a more rational approach to rail investment. A first step is to abolish price controls to remove artificial distortions to fare levels and consumer demand. The provision of new capacity should then be left to the private sector, without taxpayer support. It would make commercial sense to build new infrastructure in high demand locations where it could be funded by fare revenues or land development. Uneconomic projects driven by political motives and special-interest lobbying would no longer get built.

The economic case for phasing out subsidies is very strong. The taxes imposed on individuals and businesses to support the railways destroy jobs and hinder wealth creation in the wider economy. In addition, large parts of the rail industry could thrive without the bureaucratic micro-management that comes with government support. It may seem counter-intuitive, but removing rail subsidies could also end up benefiting passengers, by unleashing entrepreneurship and innovation on the railways that would drive down costs.

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