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Analyzing the Adverse Effects of Privatization in the Absence of Effective Regulation

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ABSTRACT

Improved infrastructure and utility delivery, increased levels of domestic and international investment, and an enlarged and vibrant private sector are urgently needed in African nations. Privatization can be used to accomplish everything mentioned above. Yet, due to sluggish and reluctance on the part of African states to privatize, a sizable amount of industrial/manufacturing and the majority of infrastructure still belong to the state Nellis (2005). Leftist intellectuals have, however, denounced the privatization of once-state-owned services as a sell-out of public goods and as the ultimate triumph of market capitalism, which has a propensity to leave the poor even more destitute and the rich much richer. Since the majority of developing countries are working to end poverty, privatization may be the answer for some. The study examines whether privatization would make poverty levels worse or worse. This essay focuses on nations in Africa. The outcomes of privatization in Africa are uneven, and it has been noted that none of the African nations have totally benefited from it. This essay examines the issue of whether privatization harms the most vulnerable members of society and uses the examples of privatization in Guinea and Senegal to do so.
Keywords: Privatization, Regulation.

Introduction

Privatization has come under fire over time. Public service delivery is not always efficient and advantageous for the underprivileged (Estache et al., 2001). When services are provided by the government, subsidies do not necessarily help the poor, and they frequently wind up paying more for services from unofficial suppliers. Privatization works best when combined with regulation. Using an empirical examination of 38 countries, Bortolotti et al. (1998) establish the importance of regulation as an institutional variable in privatization. Despite privatization, the government still has a significant influence over the creation of the legal framework and the introduction of competition. When the regulatory framework is weak, the poor suffer (Estache et al., 2000). During the transition stage privatization harms the poor as unemployment and prices rise. The effects are severe in situations where safety nets are not in place. In the long run Privatization led growth reduces poverty (Foster, 1999).

Budget deficits are decreased by privatization. From a microeconomic point of view, privatization promotes profitability and effectiveness. The study makes an effort to analyze the relationship between poverty and privatization and to balance the advantages and disadvantages of privatization from a macroeconomic standpoint. The paper makes the case that effective regulation must go hand in hand with privatization to help reduce poverty and offers the case studies of Senegal's and Guinea's privatization of water as examples of privatization failure brought on by a lack of regulation.

Economic Rationale for Privatization

The theory of public choice portrays the government bureaucrat as a neoclassical actor with a motive to maximize public budgets and power (Niskanen, 1971). Therefore, government provision of goods is expected to be excessive, inefficient and fails to meet the demands of citizens. Monopolies maximize profits and strip consumer surplus. In such cases Privatization can come to the rescue and promote efficiency and variety by introducing competition (Bel and Warner, 2008). Market forces fail to allocate resources efficiently under the cost structure of a natural monopoly. Therefore, in order to overcome the problem of inefficient resource allocation Nationalization or public regulation is necessary.

However, Privatization is not always the cure for faulty management of natural monopolies. In some situations, management reform is desirable. In situations where reform is not sufficient Privatization needs to be accompanied by regulation (Foster, 1992). The term Privatization is linked with the wish for smaller governments. Privatization can take several forms that include asset sales, deregulation and franchising. All these are forms of Privatization and may be adopted on its own or in combination with other forms. The choice regarding the form of Privatization depends on the particular industry and the social welfare maximization goals of the government. Privatization may contribute to overcoming distortionary taxation and rent seeking (Domberger and Piggot, 1986).

Proper design and implementation of Privatization can help the poor access facilities from which they were deprived off before. In Latin America the very poor could not access public utilities before Privatization and were unable to reap the benefits of expansion (Estache et al., 2001). Sometimes, Privatization is accompanied by a rise in tariffs. Effective regulation of monopolies reduces tariffs to the optimum level and costs in other sectors decline. As a result, demand increases which helps generate employment (Boetkee, 1994). In some cases, Privatization may mean a move from the informal private sector to the formal private sector. As some services are underprovided by the public sector, the poor access substitutes of water, electricity and communication from the private sector. Privatization helps boost quality of a service and if accompanied by competition then diversity will increase and services will be customized to address the needs of the poor. However, higher quality will increase costs that in turn may have an adverse effect on tariff rates. In some cases, the benefits are higher than the costs in case of poor households (Domberger and Piggot, 1986).

Moving on to the macroeconomic effects it is observed that in situations where safety nets are not in place a rise in the price of infrastructure services affect consumption. Overtime the involvement of the private sector helps promote economic growth and aids in poverty reduction. Labor turnover is high immediately after Privatization. During the transition stage employees may incur reduction in wages (Foster, 1999). In order to protect the poor policy actions must recognize the Privatization strategy, regulatory and social policy as complements. A drawback of competition is it eliminates cross-subsidies, which may hurt the poor (Estache et al. 2001). Privatization strategy must not be replicated from the developed country models; scope of alteration should exist so the price and quality combinations can be altered when necessary (Estache et al. 2001).

Critical Analysis of Privatization

Even though Privatization increases efficiency and improves financial performance it has adverse effects on distribution of wealth, income and political power (Birdsall and Nellis, 2003). Privatization needs to be implemented in such a way that it promotes both equity and efficiency in the economy by cutting down on monopoly rents. Privatization not always improves firm performance. In studies comparing Privatization where 204 Privatizations were considered it was observed that in 41 countries one-fifth to one-third firms did not demonstrate significant improvements after Privatization (Megginson & Netter, 2001). There are cases where Privatization was a success. Evidence from Chile suggests that Privatization of telecommunications and electricity increased access to the poor. Privatization can prove beneficial in eliminating informal providers of infrastructure services. Surveys from Latin America suggest that the poor are willing to pay more to achieve formal access as there is a guarantee they will receive uninterrupted supply (Estache et al., 2000). This section attempts to focus on the macroeconomic aspects of Privatization.

Distribution of Assets

Privatization involves the selling of taxpayer's assets to the private sector. Equity levels decline if assets are sold at a lower price compared to their true value. If a loss-making asset is sold off it is beneficial as it results in increased firm profitability, increased return to shareholders, increase in salaries and creates job opportunities (Kikeri and Nellis, 2004). In case of Costa Rica selling off money-losing companies proved beneficial (Sheshinski and Calva, 2003). In some situations, Privatization improves the quality and quantity of infrastructure. Inequality decreases with improvements in infrastructure and thus aids poverty reduction (Calderon and Serven, 2004). Evidence from Eastern Europe suggests that Privatization improved economic efficiency but the opportunity cost was higher unemployment and increasing poverty (Obser, 2005). In developing countries Privatization is imposed as a condition for loans, this has adverse effects as developing countries do not have proper regulatory frameworks and safety nets in place (Kessides, 2004).

Effects on Employment

The after effects of Privatization sometimes result in job cuts. Those workers who are low paid are sacked first and they find it difficult to find alternate sources of employment. Unemployment rates grew by 9 and 8 percent in Argentina and Poland respectively after reforms (Sheshinski and Calva, 2003). But if Privatization is a major component of a reform policy then Privatization is likely to create more jobs and boost employment levels. In England and Wales Privatization did not lead to severe job cuts as the government took care of overstaffing problems prior to Privatization (Harris, 1994). In case of British Airways employment levels increased after Privatization (Brau and Florio, 2004). Privatization also has impacts on the return on physical capital. If the private ownership is more efficient then spillover effects in terms of more highly paid jobs may result. In some cases, private ownership may not be efficient and this will have negative effects on equity. A study on Privatization in Argentina, Bolivia, Mexico and Nicaragua suggest that prices increased and decreased and there was unequal distribution in income due to job cuts. However, these adverse effects were outweighed by higher quality and increased access that benefitted the poor the most (McKenzie and Mookherjee, 2003).

Prices and Access

Prices may fall if Privatization leads to increased competition. If the public utility was operating at prices below the operating cost then prices are likely to rise. The distributional effect of the prices depends on the extent of consumption of the good or service by different income groups. In case of access to services, Privatization opens the market for consumption to a wider group. In some case access may be reduced because the private firm is no longer obliged to provide services to all markets and they may decide to cease providing services to a particular area that previously benefitted from public provision. In countries like Chile Privatization has helped improve access to services and improved quality (Fischer et al., 2005). In case of electricity Privatization in the Ivory Coast prices fell significantly (Plane, 1999). Improved access after Privatization can aid in poverty reduction. Leipziger et al. (2003) in their study prove that access to improved infrastructure services after Privatization has improved child health. However, the introduction of competition is expected to reduce tariffs thus ensuring access to the poor. In Argentina due to Privatization of electricity the prices fell (Estache et al., 2000).

Privatization, Regulation and Poverty Reduction

This section starts off by introducing the debate where this paper argues for Privatization with effective regulation to reduce poverty. Privatization on its own is not enough to aid poverty reduction. However, when Privatization is accompanied by effective regulation it aids the poorest. Some actions and reactions present in the traditional sphere of activities of a regulatory agency can intensify the benefits of the reform for the poor households. Strict regulatory rules are beneficial as it is possible to forecast the outcomes and are less vulnerable to corruption. Regulators need to be open to innovative measures for solving investment issues that benefit the poor. In Uganda the current regulatory framework acts as a burden and restricts the growth and development of the enterprise sector. A regulatory reform that promotes private sector development needs to be introduced and the reform must focus on areas where the costs of regulation are higher than the benefits (Kirckpatrick and Lawson, 2004). The regulator highly benefits the poor by introducing competition and expanding choice. Regulation by introducing optional tariffs can benefit the poor. Therefore, a strong regulatory structure must be in place otherwise the needs of the poor are neglected when making public policy decisions (Estache et al. 2001). An important goal of regulation is to reduce allocative inefficiency and ensure income redistribution. Distributional equity is achieved by restricting the monopoly from extracting consumer surplus. Furthermore, monopoly regulation ensures consumption of a good is at the socially optimum level and increases business confidence (Bradburd, 1995).

Regulators can adopt a combination of price regulation and rate of return regulation to benefit the poorest in society. Price regulation was designed in the UK to provide efficient transfer of pubic owned utilities to private ownership. Price regulation provides incentives to lower costs leading to higher profits. This strain the regulatory compact. Price regulation relies on the market mechanism to determine the fair rate of return. The market also determines cost reduction strategies. However, price regulation was criticized by the public and politicians for unfair distribution of rents among consumers, shareholders and managers. Rate of return regulation emerged in the United States to ensure fair distribution of rents accruing to franchise monopoly investor-owned utilities. It ensures a reduction in the variations of profitability and offers investors insurance against adverse technical progress in exchange of lower return to investors. In case of rate of return regulation, the regulated utility files a proposed set of tariffs that is fair and is enough to cover unit costs and includes the return on capital. The regulated utility also provides accounting information that includes updated operating costs, the rate base and capital cost. The new set of tariffs is approved at a public hearing (Newbery and Pollitt, 1997).

Regulation is an integral part of the Privatization programme (Bayliss, 2000). Improvements in regulatory governance are essential to ensure Privatization increases economic growth and aids in poverty reduction. Regulation can aid poverty reduction by addressing absolute poverty through economic growth and targeting relative poverty by ensuring access to public services. Economic growth is increased through stable business environment that encourages investment and entrepreneurship. Effective regulation ensures access to services by the poor in rural areas and addresses the adverse effects of Privatization by securing employment opportunities (Parker et al., 2005). Distribution is essential (Stigler, 1971). Developing countries are vulnerable to regulatory capture that adversely affects investment.

Regulatory models need to ensure social equity and economic efficiency by monitoring pricing design and access policies (World Bank, 1994, Kirkpatrick, et al., 2005). Simultaneously over-regulation needs to be taken care off by having appropriate mechanisms (World Bank, 1999). The poor have a number of roles in society. They are consumers, owners of assets and labor. All these roles need to be taken into account by the regulator for effective poverty alleviation. The regulator requires adequate information and needs to understand the ways in which the interests of the poorest are maximized (Parker et al., 2005). In Colombia public hearings are held which involve consumers and operators (Cannock, 2002). Results from the CGE model indicate positive impacts of Privatization on all segments of the society. Effective regulation is an important part of these results. Net gains are reported to be 0.9 percent of GDP and efficient regulation contributes another 0.39 percent of GDP as surplus gain (Sheshinski and Calva, 2003).

However, regulators are criticized for their closed-door decisions (Carino, 2005). A major problem in developing countries is regulatory models are replicated from developed countries as a result the main target is economic efficiency and these models do not focus on poverty alleviation. In developing countries regulators do not have adequate skills to carry out effective regulations and the regulatory agencies are under-staffed. In developing countries, a big challenge is ensuring access to services at a subsidized rate for the poor (Parker et al., 2005). The main reason for failure of reforms in infrastructure in Argentina is lack of effective regulation. In such situations the poor lose out (Ugaz and Price, 2003). In developing countries newly formed regulatory bodies lack the capacity to balance economic efficiency and poverty reduction (Parker et al., 2005). Barrera-Osorio and Olivera (2007) examine the effects of water Privatization in Columbia. Their findings show positive effects of Privatization. Privatization has improved access to water in urban areas and in the rural privatized areas water borne diseases were reduced and child health improved. Due to removal of subsidies prices rose but increasing prices were offset by health improvements.

The World Bank has taken steps to ensure that the poor benefit from Privatization. They have extended loan repayment periods recognizing that sustainable service along with full cost recovery is only possible in the long term. In order to encourage investments so that services reach the poor the World Bank has agreed on providing subsidies. The poor will reap the benefits of reform if the project has a poverty alleviation focus (Roaf, 2006). Privatization complemented by efficient regulation will ensure firms cut down on costs and reduce prices and thus ensure access to the poor in remote areas (Parker, 2003).Therefore, a regulation agenda that takes into account efficiency and poverty alleviation will make the effects of Privatization more desirable.

Case Study- Impacts of Privatization in Africa

Water Privatization has been used as a method of reform in several African countries but the methods used have been faulty. Boccanfuso et al., (2005) in their study use a CGE model to analyze the impact of water Privatization on poverty and inequality. Their findings show that the private firms and the government benefit but the poor lose out. This section compares the Privatization impacts on Guinea and Senegal.

Pre-Privatization Situation

Service provision by the water sector in Guinea was dissatisfactory before the reform in 1989. People did not have access to water and the rates of water borne diseases were very high. The water sector failed to develop due to political interference and adverse economic climate. Less than 40 percent of the urban population could obtain piped water. The water supply facility was providing poor service but Privatization was not the only solution to the problem. Guinea had to privatize water due to the requirement of investment finance and the need for better quality services. These were not the only reasons. A major reason was due to donor pressure. The government had a deficit of funds. The World Bank Imposed Privatization as a condition for providing loans (Christian Aid, 2001). In Guinea water supply was adequate but poor provision was a result of mismanagement. The urban elite and the workers were the victims who would suffer from Privatization impacts. There would be job cuts as the public utility was overstaffed. Previously these groups of people had suffered due to structural adjustment policies and rise in agricultural prices (Bayliss, 2001).

In case of Senegal the water sector was privately owned before independence and was later nationalized in 1972.During 1970's there was adequate investment but the full benefits could not be reaped due to mismanagement and too advanced installations that were difficult to maintain. However, nationalist failed to bring the desired impacts. The government was unable to increase tariffs and intervene in investment decisions. Public authorities did not pay bills properly. Although operational performance was satisfactory the water sector failed to cover costs with revenue. Therefore, the solution was Privatization (Bayliss, 2001). The main aim was to improve access to finance. The efficiency gains brought about by the private sector would require increase in tariffs to cover the costs. Efficiency gains of Privatization were likely to be high. Annual price increase was expected to be 2.4 percent to cover costs compared to 5 percent without private participation. Privatization was essential to ensure autonomy from government and put pressure on public bodies to pay bills (Boccanfuso et al., 2005).

The Process

In 1989 the government handed over the ownership of urban water supply to Societe Nationale des Eaux de Guinea (SONEG). This was the new state-owned national water authority. Private companies were asked to bid for a lease arrangement to operate and manage the urban water services in 17 urban centers. The contract was signed by Societe de Exploitation des Eaux de Guinee (SEEG). This was supported by funds from the World Bank, African Development Bank, the government of Guinea and SONEG. A joint decision was made to increase prices to allow the private sector to generate revenue. The World Bank subsidized prices and the revenue directly went to the private firms (Bayliss, 2001).

In case of Senegal a lease contract was signed with the private operating company, Senegalaise des Eaux (SdE) in 1996. SdE was responsible for some yearly investments. SONES a government state holding company had ownership of sector assets and was in charge of planning and financing investments and monitoring SdE. SONES had a record of good performance so was retained as a public entity in the water sector and the employees were also included in the reform process. SONES received the difference between total consumer tariffs and SDE's remuneration (Bayliss, 2001).

Post-Privatization Situation

In Guinea the desired outcome was not achieved. There were improvements in water quality and customer service. Almost all customers had working meters. Bill collection improved but deteriorated when prices were increased. The government still does not pay regularly and law enforcement is not present. There were improvements in factor productivity but job cuts were high. The price increase was higher than anticipated. In Guinea prices and tariffs are higher compared to the African region. Even the wealthy found it hard to pay bills. Investment levels increased but could not be sustained due to high levels of unaccounted for water. The increase in connections was lower than expected (Bayliss, 2001).

In Senegal population with access to safe drinking water increased by 4% and there have been significant reductions is unaccounted for water. Furthermore, the target levels were not met due to confusions and tension between SONES and SdE (Bayliss, 2001).

Limitations

In case of Guinea the targets were not met due to the following:

Undefined Responsibilities

The overlapping functions of SONEG and SEEG have led to disputes. Investment delays have caused them to blame each other.

Weak Regulation

SONEG cannot access SEEG's financial information. Therefore, when SEEG urges for a tariff rise SONEG has no idea why SEEG wants to increase tariff. The government will not know if SEEG is using transfer pricing to maximize profits. If manipulation occurs to ensure profits are maximized this will not be beneficial for Guinea's water services. Weak regulation is an advantage to SEEG and results in asymmetric information. It is very easy (Bayliss, 2001) for SEEG to overstate its costs. Efficient regulation should ensure transparency of information between SEEG and SONEG.

Findings of a World Bank audit show that due to weak regulation tariffs have been overvalued. As a result, SEEG received higher compensation. This was due to poor administration and lack of transparency by SEEG.

Absence of an Independent Regulator

Due to absence of an independent regulator bills have not been paid and the system lacks transparency. Effective monitoring and regulation is essential for successful reform.

In case of Senegal the limitations were the presence of individual bodies for investment and maintenance. SdE is regulated by SONES, which employs former employees of SdE. These employees are paid less compared to their previous colleagues. Tariff adjustments are running smoothly and public entities pay their bills. There remains tension between the private operator and SONES (Bayliss, 2001).

Policy Recommendations

1. In order to ensure Privatization benefits the poor Privatization strategy, regulatory policy and social policy needs to be taken into account simultaneously.
2. Regulators must be provided with independence in making decisions for Privatization to have fruitful results and the regulatory body needs to be formed at the beginning of the reform programme to operate better (Davies et al, 2005).
3. Institutions relevant to the reform process need to be transparent and adequate and a regulatory framework that protects the private sector from political intervention and encourages competition needs to be in place (Tan, 2008).
4. Privatization strategies must not be replicated but must be customized to meet the needs of the poor in developing countries.
5. The regulatory framework must consider each country's unique political, legal and institutional context (World Bank, 2004).

Conclusion

The advantages of privatization are not always denied to the underprivileged. The creation of competition favors the underprivileged. Strategies for privatization should be created specifically to satisfy the demands of developing countries rather than being implemented based on the framework of industrialized countries. The two case studies reveal that privatizing water in Africa has only led to advancements in a few key areas of revenue generation. Rates for tariffs, billing, and collection have all increased. The poorest are the major losers from the privatization process, as seen by high costs and disconnections. The absence of regulation was a crucial factor in why privatizing water did not help the underprivileged. As a result, we can draw the conclusion that unregulated privatization is bad for the poorest. Since the regulators play the most significant role in ensuring the success of privatization, future study can concentrate more on the role of the regulator and solutions need to be offered in order to make them more successful. Future study can also concentrate on the drawbacks of overly strict regulation. Privatization benefits private businesses whose efforts are geared toward increasing income, such as meter installation. Private companies are in charge of making decisions. They choose how much to pay the government after receiving tariffs. The case studies also make it very evident that proper regulation is required. However, research from Bolivia reveals that, when compared to privatizing other types of infrastructure, privatizing water benefits the poor the most (Ajwad and Woodon, 2000).

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