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Is privatisation without effective regulation bad for the poorest?

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Abstract
There is an urgent need of more efficient and effective infrastructure/utility provision, a boost in investment levels from both domestic and foreign sources and an expanded and dynamic private sector in African countries. All of the above can be achieved through privatisation. However, African states have been slow and reluctant privatisers as a result a significant proportion of industrial/manufacturing and most infrastructures still belong to the state Nellis (2005). However, Leftist thinkers have condemned the privatisation of former state-owned services as a sell-out of public goods and as a final victory of market capitalism that has a tendency to make the rich even richer and more affluent and the poor more destitute. As most developing nations are focused on reducing poverty for some privatisation may be the way out. The paper explores how privatisation may reduce or increase poverty levels. The focus of this paper is on African countries. The results of privatisation in Africa are mixed and it is observed that privatisation has not been entirely successful for any of the African countries.[26] This paper attempts to analyse whether privatisation without effective regulation is bad for the poorest in society and illustrates the case of privatisation in Guinea and Senegal.
Keywords: Privatisation, Africa, Poverty Reduction, Regulation

1. Introduction

Over the years privatisation has been criticised. Public provision of services is not always effective and beneficial for the poor (Estache et al., 2001). In case of public provision subsidies do not always benefit the poor and the poor end up paying more for services from informal providers. Privatisation when integrated with regulation is effective. Bortolotti et al. (1998) proves from an empirical analysis of 38 countries that regulation is a vital institutional variable in privatisation. After privatisation the government continues to play an important role in setting up the regulatory framework and controls the introduction of competition. In cases where the regulatory structure is frail the poor lose out (Estache et al., 2000). During the transition stage privatisation 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 privatisation led growth reduces poverty (Foster, 1999). Privatisation reduces budget deficits. If privatisation is viewed from a microeconomic perspective profitability and efficiency increases. The paper attempts to analyse aspects of the poverty-privatisation nexus and tries to weigh the costs and benefits of privatisation from a macro-economic perspective. The paper argues that privatisation needs to be combined with effective regulation to aid in poverty reduction and uses the case studies of water privatisation in Senegal and Guinea as examples of privatisation failure due to lack of regulation.

2. Economic Rationale for Privatisation

The theory of public choice portrays the government bureaucrat as a neoclassical actor with a motive to maximise 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 maximise profits and strip consumer surplus. In such cases privatisation 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 Nationalisation or public regulation is necessary. However, Privatisation 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 privatisation needs to be accompanied by regulation (Foster, 1992). The term Privatisation is linked with the wish for smaller governments. Privatisation can take several forms that include asset sales, deregulation and franchising. All these are forms of privatisation and may be adopted on its own or in combination with other forms. The choice regarding the form of privatisation depends on the particular industry and the social welfare maximisation goals of the government. Privatisation may contribute to overcoming distortionary taxation and rent seeking (Domberger and Piggot, 1986).

[26] http://www.ascleiden.nl/content/webdossiers/privatization-africa

Proper design and implementation of privatisation 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 privatisation and were unable to reap the benefits of expansion (Estache et al., 2001). Sometimes privatisation 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 privatisation 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. Privatisation helps boost quality of a service and if accompanied by competition then diversity will increase and services will be customised 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. Labour turnover is high immediately after privatisation. During the transition stage employees may incur reduction in wages (Foster, 1999). In order to protect the poor policy actions must recognise the privatisation 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). Privatisation 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).

3. Critical analysis of Privatisation

Even though privatisation increases efficiency and improves financial performance it has adverse effects on distribution of wealth, income and political power (Birdsall and Nellis, 2003). Privatisation needs to be implemented in such a way that it promotes both equity and efficiency in the economy by cutting down on monopoly rents. Privatisation not always improves firm performance. In studies comparing privatisation where 204 privatisations were considered it was observed that in 41 countries one-fifth to one-third firms did not demonstrate significant improvements after privatisation (Megginson & Netter, 2001). There are cases where privatisation was a success. Evidence from Chile suggests that privatisation of telecommunications and electricity increased access to the poor. Privatisation 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 privatisation.

3.1 Distribution of Assets

Privatisation 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 privatisation 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 privatisation improved economic efficiency but the opportunity cost was higher unemployment and increasing poverty (Obser, 2005). In developing countries privatisation 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).

3.2 Effects on Employment

The after effects of privatisation 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 privatisation is a major component of a reform policy then privatisation is likely to create more jobs and boost employment levels. In England and Wales privatisation did not lead to severe job cuts as the government took care off overstaffing problems prior to privatisation (Harris, 1994). In case of British Airways employment levels increased after privatisation (Brau and Florio, 2004). Privatisation 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 privatisation 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).

3.3 Prices and access

Prices may fall if privatisation 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, privatisation 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 privatisation has helped improve access to services and improved quality (Fischer et al., 2005). In case of electricity privatisation in the Ivory Coast prices fell significantly (Plane, 1999). Improved access after privatisation can aid in poverty reduction. Leipziger et al. (2003) in their study prove that access to improved infrastructure services after privatisation has improved child health. However, the introduction of competition is expected to reduce tariffs thus ensuring access to the poor. In Argentina due to privatisation of electricity the prices fell (Estache et al., 2000).

4. Privatisation, Regulation and Poverty Reduction

This section starts off by introducing the debate where this paper argues for privatisation with effective regulation to reduce poverty. Privatisation on its own is not enough to aid poverty reduction. However, when privatisation 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 strains 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 criticised 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 privatisation programme (Bayliss, 2000). Improvements in regulatory governance are essential to ensure privatisation 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 privatisation by securing employment opportunities (Parker et al., 2005). Awareness against "regulatory capture" which leads to regressive impacts on income 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 labour. 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 maximised (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 privatisation 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 criticised 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 subsidised 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 privatisation in Columbia. Their findings show positive effects of privatisation. Privatisation has improved access to water in urban areas and in the rural privatised 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 privatisation. They have extended loan repayment periods recognising 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). Privatisation 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 privatisation more desirable.

5. Case Study- Impacts of Privatisation in Africa

Water Privatisation 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 analyse the impact of water privatisation on poverty and inequality. Their findings show that the private firms and the government benefit but the poor lose out. This section compares the privatisation impacts on Guinea and Senegal.

5.1 Pre-Privatisation 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 privatisation was not the only solution to the problem. Guinea had to privatise 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 privatisation 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 privatisation 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 nationalised 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, nationalilsation 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 privatisation (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 privatisation 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. Privatisation was essential to ensure autonomy from government and put pressure on public bodies to pay bills (Boccanfuso et al., 2005).

5.2 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 centres. 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 subsidised 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).

5.3 Post-Privatisation 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 has been significant reductions is unaccounted for water. Futhermore, the target levels were not met due to confusions and tension between SONES and SdE (Bayliss, 2001).

5.4 Limitations

In case of Guinea the targets were not met due to the following[27]:

5.4.1 Undefined responsibilities

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

5.4.2 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 maximise profits. If manipulation occurs to ensure profits are maximised 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

[27] (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.

5.4.3 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).

6. Policy Recommendations
- In order to ensure privatisation benefits the poor privatisation strategy, regulatory policy and social policy needs to be taken into account simultaneously.
- Regulators must be provided with independence in making decisions for privatisation 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).
- 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).
- Privatisation strategies must not be replicated but must be customised to meet the needs of the poor in developing countrires.
- The regulatory framework must consider each country’s unique political, legal and institutional context (World Bank, 2004).

7. Conclusion
The poor are not always deprived from the benefits of privatisation. Introduction of competition benefits the poor. Privatisation strategies should not be adopted based on the developed country framework but needs to be tailored to meet the needs of developing countries. The two case studies show that privatisation of water in Africa has only demonstrated improvements in some of the core aspects of raising revenue. Tariffs, billing and collection rates have improved. High prices and disconnections indicate that the poorest are the main losers from the privatisation process. A major reason why privatisation of water was ineffective in benefitting the poor was the lack of regulation. Therefore, we can conclude that privatisation without regulation harms the poorest. Future research can focus more on the role of the regulator and measures need to be suggested in order to make them more effective since the regulators play the most important role in ensuring privatisation is a success. In addition, future research can also focus on the downsides of excessive regulation. The private companies whose investments are focused on revenue raising such as meter installation gain from privatisation. Private firms hold decision-making power. They receive tariffs and decide what to pay the government. Furthermore, the case studies clearly indicate the need for effective regulation. However, evidence from Bolivia suggests that the poor benefit the most from water privatisation compared to privatisation in other forms of infrastructure (Ajwad and Woodon, 2000).

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