

Impact of privatisation without effective regulation



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Discuss the view:

Privatisation without effective regulation is unlikely to bring significant benefits to developing countries.

Despite its abundance around the world, and the apparent high esteem that governments hold it in, regulation is no longer seen as the panacea it once was. Regulation must not be over used. Put simply, regulation provides benefits but also incurs costs. Regarding the benefits, Garg and Karba, quoted in Jacobs (2006: 5) have said that,

“ it is widely acknowledged that sound regulation is the key to good governance and increased regulatory effectiveness in turn means a better government.”

At the same time, the European Parliament (2002) has drawn attention to,

“ The problems of over-regulation, the doubtful quality of the laws and the economic obstacles that arise in consequence are increasingly the subject of debate.”

Whenever regulation is contemplated, it is necessary to assess whether the costs of such regulation are outweighed by the benefits they provide. This is achieved using Regulatory Impact Assessment (RIA), which involves “ a systematic process for assessing the significant impacts (positive and negative) of a regulatory measure” (Jacobs, 2006).

This paper looks at the potential benefits and costs that result from regulation of privatised industries in developing countries and whether

privatisation without regulation is capable of benefitting a developing economy. The costs of regulation are generally economic, with regulation creating compliance costs for companies, and enforcement costs and added layers of bureaucracy for governments. The benefits may be economic, such as increasing competition in a market, but may also be institutional, increasing a government's institutional capacity, or social, raising an awareness of the regulated issues among policy makers or the general public which would not otherwise have been present. From a governance perspective, regulation may improve the efficiency and transparency of the government and increase its institutional capacity, but there is also a risk that the added bureaucracy might create new opportunities for corruption and rent seeking. This paper looks therefore, not only at the economic costs and benefits of regulation, but also from a governance and social perspective.

Furthermore, Bayliss (2002) has pointed out that there has been a shift in emphasis when assessing the effectiveness of economic reforms in developing countries. As she points out,

“ Greater attention is now paid to the poverty impact of economic policies in developing countries. Whereas previously the focus was on macroeconomic reforms, effectiveness is now considered in terms of the impact of policies on the poorest.”

This can be seen in the recent replacement by the World Bank of Structural Adjustment Programmes (SAPs) with Poverty Reduction Strategies (PRs), and similarly with the International Monetary Fund's (IMFs') change from

offering Enhanced Structural Adjustment Facilities (ESAFs) to offering Poverty Reduction and Growth Facilities (PRGFs) in 1999 (Bayliss, 2002: 2).

Therefore, when assessing the benefits of regulation of privatisation, this paper will do so from the perspective of poverty reduction where possible, as opposed to merely macroeconomic benefits.

Finally, it must also be borne in mind that privatisation is a complicated and often disputed process. Therefore, when this paper will also examine many of the difficulties that privatisation can raise for the development of an economy and will look at the many instances in which privatisation will create challenges for the economy which regulation will not be able to assist with.

Regulation: costs and benefits

Looking first at regulation of privatisation, the OECD (2001) has pointed out that when conducted correctly, and with effective regulation, including the inclusion of effective RIA measures,

“[regulation] will increase the understanding of the impact of government policies, help unite different interests and approaches to problems, improve public governance transparency and increase the responsibility in public resource management.”

Regulatory best practice dictates that regulations should be drafted so as to minimise the burdens they place on the regulated sector while achieving the desired results. However, it has also been pointed out that regulations often have unintended side effects that impact on groups who were not intended

to be the targets of the regulation (European Parliament, 2002). Garg and Kabra (2004) have identified four issues that must be considered if regulation is to be effective:

firstly all the impacts of proposed regulation, including unintended impacts, must be considered;

secondly, the policy objectives of the regulation should be carefully examined to ensure that they do not conflict and to ensure also that all objectives are adequately addressed by the proposed regulations;

thirdly, development and implementation of the regulatory framework must be carried out in an inclusive, consultative and transparent manner; and

fourthly, the government and the regulator must be accountable.

If these four requirements are met, then according to Garg and Kabra (2004), the process of regulation also “ has the potential to be a force for open and democratic government.”

However, such regulation, according to Jacobs (2005), are not of benefit to all types of government. He states,

“ the prevailing wisdom is that benefits correspond to those of democracies or ‘ good government’. [Regulation and RIA] support legal governments which observe the rule of law with proportionate and equitable law. An accountable government is promoted through assessing direct costs and benefits that citizens will incur and selecting policies on the basis of best value for money, taking into account redistribution effects.”

Clearly, there are significant benefits to be gained if the right type of government goes about regulation in the correct manner. If the regulations are developed in a consultative manner then they will also help raise awareness of the relevant issues. Effective regulation of core industries, as well as open and accountable RIA procedures are also “ considered as fostering processes conducive to democracies” (Jacobs, 2005). However, if an autocratic or corrupt government were to regulate the industry the same benefits would not be reaped. It is difficult to see how such governments would go about creating a consultative and transparent regulatory regime in any case. This means that they would find it difficult to create a regulatory regime that adequately addressed the myriad different objectives of the regime. It would also mean that there is a high risk that the regulations put in place would have side effects for other, supposedly non-regulated sectors, which would further increase the burden of regulation.

It is suggested in this paper that regulatory frameworks implemented by immature or non-consultative governments are likely to lack the necessary degree of subtlety that is gained when proper consultative processes are in place, and therefore, the regulations put in place by such regimes may be damaging.

To conclude, if regulation is to be of any benefit in the privatisation process, it must be carried out by a responsible and open government, using consultation and adopting regular Regulation Impact Assessments.

Otherwise, regulation alone will be of no benefit and will merely add an extra layer of bureaucracy, cost and possibly corruption, into the equation.

Also, if regulation is carried out correctly, it will have the side effect of increasing the institutional capacity and expertise of the government.

The European Commission (2002), in assessing Slovakia's regulatory measures stated,

“ despite the progress made over the past year, the major need now consists of building up adequate administrative structures and strengthening of administrative capacity to implement the acquis.”

Clearly, in order to be of benefit, regulations require certain institutional elements to be put in place by the government. This includes proper oversight of regulators as well as procedures to assess the impact of regulations and the effect they are having on industry. Therefore, it is again suggested that regulations put in place by administrations which lack capacity for effective RIA may also prove damaging to a privatised industry. Even where the government is genuinely democratic and seeks only to improve the performance of the regulated industry for the good of citizens, if it does not have adequate institutional capacity it may find it difficult to pull this off without harming the economy.

Privatisation: the challenges for alleviating poverty and the potential for regulation to assist

Looking next at the process of privatisation, Bayliss (2002) has pointed out that privatisation has long been one of the favoured methods by which international financial institutions (IFIs) have sought to alleviate poverty in developing countries. However, she states that they were popular when

macroeconomic considerations were the main concern of the IFIs and that they have continued into the present days of poverty reduction largely on an assumption that what is good for the macro economy is good for poverty reduction. She states,

“ the impact of privatisation on poverty has so far been neglected in World Bank analysis. The distributional impact of privatisation transactions will depend on the nature of the enterprise in question.”

Privatisation is generally seen as a benefit both because it raises revenues for the government, while at the same time increasing competition in core and vital sectors of the economy, such as the provision of utilities and transportation. The degree to which a privatisation generates revenue for government depends on the price achieved for the company sold. However, as stated above, benefits today must be assessed according to the poverty alleviating affect, rather than their merely structural effects and from this perspective, the main benefit of a privatisation is far more likely to be the better service that citizens or customers get from the privatised industry. This of course will vary depending on the nature of the industry and the degree to which it is essential to poor people, and also the degree to which the industry has been monopolised by the national company. The privatisation of an essential industry such as water or electricity, previously supplied by a single company, is likely to have a larger impact on poverty reduction than the privatisation of a state owned steel mill for example, especially if there are already private steel mills operating in the sector. If the service offered by the industry to be privatised is actually used by the poor, then the potential benefits to the poor are naturally higher (Bayliss, <https://assignbuster.com/impact-of-privatisation-without-effective-regulation/>

2002). Likewise, since much of the improvement in an industry post privatisation comes from increased competition, the market share of the national industry prior to privatisation is also highly relevant.

It was the Berg report (Williams, 1981: 186) that first drew IFI attention to privatisation as a means of locking-in economic improvements in Africa. The World Bank had been pursuing a policy of public sector reform, with Africa's public sector seen as both dominating the private sector and under-performing. However, when improvements in efficiency were made in the public sector, they often proved difficult to maintain as governments would go back on the difficult policies that had led to the improvements. It was concluded in the Berg report that privatising an underperforming public industry would be far more difficult for a government to 'undo', so to speak. According to Bayliss and Cramer (2001)

“ privatisation acquired its own momentum and became a panacea for all that was wrong with the economies of industrialised and developing countries.”

Rebranded today as Private Sector Participation, the World Bank and the IMF still promote privatisation, have made it part of their conditionality arrangements with most states for the release of aid funds, and have increased the capacity of their own divisions dealing with the private sector (Grusky, 2001). Even privatisation of basic services has been made a requirement for IMF and World Bank programmes (Bayliss, 2001a).

Privatisation is now a core part of Poverty Reduction Strategy Papers (PRSPs) with the Uganda PRSP stating for example,

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“ In the long run privatisation will transfer the need for major investment expenditures on to the private sector” (IMF, 2000).

The Burkina Faso PRSP states it will begin the,

“ privatisation of existing state interests in order to facilitate the entry of new firms, resources, and technology into various segments of the market” (World Bank, 2002).

Privatisation strategies are also a requirement for countries to qualify under the Heavily Indebted Poor Countries (HIPC) programme.

One result of these conditionalities is that it incentivises governments of poor countries to privatise without taking into account adequately the economic benefits of doing so, especially the impact that privatisation might have on the poorest members of society. Privatisation deals will be pushed through in order to meet IMF and World Bank requirements regardless of the results of economic studies (Bayliss, 2002). One example of this was the hasty privatisation of Cameroon’s sole water utility when only one bidder had time to come forward. It is difficult to see how the best price could be achieved for the utility without proper bidding from multiple competing bidders. However, according to Reuters (2000), the utility was sold to the French MNC, Suez Lyonnaise in order to meet an IMF debt relief deadline regardless of the fact that the best price might not have been achieved.

From an examination of statements by the World Bank and wider literature there appears to be five ways in which privatisation can bring significant benefits to developing countries from the point of view of poverty reduction.

These five potential benefits will now be critically assessed, with special attention being paid to the degree to which regulation impact on such potential gains.

The first general argument in favour of privatisation is that it contributes to economic growth. Economic growth is necessary to reduce poverty.

However, Bayliss (2002) and Cook and Uchida (2001) have pointed out that the link between privatisation and economic growth in developing countries is an assumption based on experience in developed economies and has not been substantiated in the literature of the World Bank or the IMF.

Furthermore, there is no evidence to suggest that regulation would impact on the degree to which privatisation might impact on economic development. Bayliss (2002) and Cook and Uchida (2001) both reject that privatisation necessarily leads to economic growth. It is also suggested here that economic growth cannot be regulated for. For example, forcing private operators to increase production through regulation, without there being a demand would be unsustainable. Therefore, it must be concluded that the argument that economic growth generated from privatisation has a significant impact on poverty reduction is not shown, either from past experience or from empirical literature. And furthermore, regulation will not have an impact on this fact.

Secondly, the World Bank (2001) and others (Adam et al 1992) have argued that privatisation leads to Private Sector Development (PSD) and thus helps in reducing poverty. While PSD has been shown to impact positively on poverty reduction, privatisation has not as yet been linked empirically to PSD (Bayliss, 2002). The World Bank and IMF “ see the mission as being the need

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to harness the dynamism and efficiency of the private sector to make it operate for the social good” (Bayliss, 2002). It is true that in efficient and competitive markets firms must strive for efficiency and innovation in order to maximise profits and even survive. However, as argued by Bayliss (2000) “ where there is any kind of market power exercised by a single or group of enterprises, the implications for the social good come into question.” The link between privatisation and private sector development made by the World Bank and IMF is an assumption that has not been substantiated and the reasoning of the World Bank here has been harshly criticised in the literature (Bayliss, 2001b). The World Bank claims that privatisation improves the public sector in two ways. Firstly, according to Kikeri et al (1994), privatisation will increase the number of stakeholders who have an interest in the success of the countries private sector. Secondly, Kikeri et al (1992) have pointed out that privatisation is a signal to investors that the government is committed to PSD and thus investment will be encouraged. However, Bayliss (2002) has pointed out that, according to past experience in developing countries, private actors have done more harm than good to the private sector when they are put into monopolistic positions. It is only when effective regulations are put in place and enforced that the private actors have shown any tendency to behave in a manner conducive to PSD. This has led Bayliss (2002) to conclude that “ it is not privatisation that will develop the private sector; rather it is the government, through effective regulation.” She argues that such regulation will develop the private sector regardless of whether or not privatisation takes place, however, it is suggested here that if effective government regulation is in place and is enforced, then the arguments of Kikeri et al (1992) and Kikeri et al (1994)

should hold true, and therefore, privatisation with effective regulation will greatly improve PSD. Ramamurti (1996) for example, has shown that privatisation in Latin America, coupled with effective regulation, has been accepted by the markets as a positive signal to investors. It should be noted however that the same benefits have not as yet been demonstrated in Africa. Bayliss (2002) has suggested that “ arguably, government concessions and guarantees are a greater attraction for investors than a commitment to private sector led growth.” However, it is concluded here that a government commitment to PSD, coupled with effective regulation to prevent private sector abuse, should be capable of showing the same benefits in Africa as it has in Latin America if it is sustained by governments. Therefore, in this second category, privatisation can be of benefit to a developing economy, however, this will be true only if proper regulation is established.

The third way in which privatisation helps with poverty reduction is by raising government revenues through the sale of the asset. The sale will also free the government from the obligation to invest in the industry, thus providing further fiscal benefits (Campbell-White & Bhatia, 1998). The World Bank (2001) state,

“ Urban power, water, sanitation and telecommunications require large investments, even if efficiency is improved. But much of this funding can come from the private sector - indeed, privatisation can be a source of revenue for cash-strapped governments.”

The idea being that such savings can “ enable [governments] to conserve limited public resources for other priorities, such as education and healthcare” (World Bank, 2000). However, Campbell-White and Bhatia (1998) have shown the very obvious fact that private firms only want to buy profitable enterprises. Their study of privatisations in Africa shows that on aggregate, the industries that had been privatised up until 1998 in Africa had not been a financial drain on governments. It is very difficult to see many cases in which private investors will be willing to purchase loss making enterprises and then make the investments necessary to improve public services for the poorest. This fundamental fact was demonstrated by Biwater President, Richard Fleming, when his company pulled out of a private water project in Zimbabwe which was designed to bring water to some of the country’s poor. It emerged that the water tariff that had been agreed with the Zimbabwean government, and which would have allowed the project to operate at a profit, was too high for the intended customers to afford. Whiting, in an honest and realistic press release to the Zimbabwe Independent of 10 December 1999, stated on behalf of Biwater,

“ Investors need to be convinced that they will get reasonable returns... The issues we consider include who the end users are and whether they are able to afford the water tariffs... From a social point of view, these kinds of projects are viable but unfortunately from a private sector point of view they are not.”

It is inevitable that if the numbers simply do not add up, then the greatest will and best practices in the world will not enable the private sector to be involved in an industry. It is suggested here that sound regulation will not be

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able to alter this fact. The Zimbabwe Biwater case illustrates this point. The company and the government had carefully negotiated a project that was fair to everyone and would have been well regulated. Biwater was to build the infrastructure, and make a return by charging customers a tariff which had been agreed with the regulator. The problem was simple economic reality. The intended customers could not afford the tariff that the regulator had set and which the company needed to justify the investment.

Government guarantees to investors, such as guaranteeing a certain profit margin, or promising to purchase the output of a project at a guaranteed price, it is suggested, return the financial risk to the government and remove any fiscal benefits that privatisation might have been able to provide. Bayliss and Hall (2000) have identified a number of projects in which national or regional budgets have been crippled because of commitments to purchase products from privatised industries at fixed prices. Therefore, from the point of view of raising revenue for the government, privatisation may be of benefit. However, regardless of how much money a government gets for selling an asset, such gains will only be lasting if the project as a whole is feasible and the private company is able to operate at a profit. Therefore, in this third category of generating revenue for government, it is essential that the project is a success for the private company, the end user and the government, and the only way to ensure this is if effective and consultative regulation has been put into place prior to the initiation of the project.

Fourthly, it is argued that privatisation will not only bring in revenue and investment, but also foreign expertise and management practices which will increase efficiency and performance. The argument that private sector

management will be better than public sector management may be true in some situations but there are dozens of well known, multi-billion dollar privatisations in which the new management failed and the industry had to come back into public sector responsibility (Bayliss, 2002). For example, when Trinidad contracted out management of the island's water supply to UK company, Severn Trent in 1996, the company promised, through better expertise and international management best practices, to make water supply on the island break even financially within three years. However, at the end of the three year term, Severn Trent had increased the budget deficit of the utility to \$378. 5 and handed the industry back to the government, at the end of their contract, in a state of financial emergency. Regulation may be of assistance here as it can ensure that private sector management is supervised and that any failings or poor practices by the private industry will be quickly caught by the regulator. This can help avoid situations such as referred to above in which the private company has allowed an industry to deteriorate to such an extent that the government has had to step in to remedy the situation. It is suggested here that if regulation is effective and well drafted, it should decrease the risks that private management will fail drastically in its task. However, if the good management practices of the newly privatised industry are coming from the government regulator rather than from the international expertise that have been imported during privatisation, then it is difficult to see how such private expertise are of any benefit to a country. However, there are numerous cases in which privatisations have improved an industry because of international private sector expertise and it is suggested here that regulation is simply a safeguard. While it is always hoped that privatisation will lead to

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the importing of new private management who will be able to improve performance because of their expertise, the risk that they will fail is also insured against by close and effective regulation. In this case therefore, regulation removes or reduces one of the risks of privatisation, that the private management will be incompetent.

The fifth and final argument that privatisation helps a local economy is that it will cause a release of aid funds. As stated above, aid funds are often conditional upon privatisation. For example, when Guinea handed management of the capital's water sector to the private sector it received an extra \$67 million for investment in water infrastructure (Bayliss, 2002).

Menard, Clarke and Zuluaga (2000) have shown that many privatisations have been pursued solely to receive extra aid and in economic impact assessments, the extra aid is often what tips the scale in favour of privatisation. Nickson (2001) has described how the privatisation of Cartagena's water system by one mayor was only continued by the incoming mayor because of the aid funds that were tied to the deal. Without the tied in aid funds, the incoming mayor would have strongly opposed the privatisation on a number of economic and social grounds. However, it is pointed out here that the inflow of aid funds is not an inherent benefit of privatisation and only ensures that privatisation appears to be good for the economy. In fact, tying aid to privatisation makes it very difficult to assess the economic benefits of privatisation at all. It is like trying to assess the economic contribution of an industry that receives large government subsidies. The subsidies mask the true performance of the industry and make it's economic contribution difficult to ascertain. It is suggested here

however that if aid is also conditional on privatisations being regulated, then clearly there is an economic benefit to regulation, simply because it will meet with donor approval and cause the release of further funds.

Conclusion

To conclude therefore, if regulation is to be of any benefit, it must be conducted by a democratic and transparent government who is willing to address the many costs and benefits of regulation. The government must also conduct RIA to ensure that the regulations themselves do not become a burden on the industry or distort the economics of the privatised sector.

That said, in relation to the five ways in which privatisation is said to help an economy, regulation can only impact positively on some of them. With regard to the argument that privatisation contributes to economic growth, it has been shown that regulation is not a useful tool to ensure this occurs.

With regard to the argument that privatisation contributes to Private Sector Development, it is concluded here that regulation is necessary and effective. Without such regulation there is a risk that privatised firms will behave in a monopolistic and abusive manner. Therefore for privatisation to improve the public sector, it must be properly regulated. With regard to the argument that privatisation has fiscal benefits for the government, this will only be the case if the privatised industry is carefully regulated so as not to create costs for the government in the event of bad management. However, in this regard, the terms of the privatisation agreement are more important than regulation. With regard to the argument that privatisation brings in foreign expertise, this is true in many cases but again, in order to reduce the risk

that the privatised firms perform poorly, regulation is again necessary. And finally, with regard to the argument that privatisation attracts aid, insofar as aid is conditional on privatisation being regulated, then regulation has a direct benefit of pleasing aid agencies.

Therefore, while the benefits of privatisation are still being disputed, with regard to the World Bank's five asserted benefits of privatisation, four of them are enhanced if effective regulation is in place. Therefore only way in which developing countries can benefit from privatisation is with effective regulation.

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