Privatisation of public services and the natural monopoly

In the recent decades, many of the developing countries adopted privatisation policy as a form of diversification of the national income resources and to enable the private sector to participate in developing the national economy, in the meaning that, the private sector can deliver quality products and services more efficiently and at a much lower cost price.

This essay takes a look at the arguments and evidence for and against privatising public services as an example of Oman. It is not intended to be an analysis or comparison of the actual facts involved, but rather an overview of the concept itself, in one developing country (Oman) which starting this policy recently.

Privatisation in Oman was initiated in the year 1988 when the government sold some of its shares in Oman Flour Mills Company. Since then, and up to the year, a number of privatisation projects concerning government have been completed. The government still owns shares of more than 30 companies and establishments. Some of these are being restructured in preparation for privatisation in future.

2. Arguments for and against Privatisation:

The term “ privatisation” refers to the process of private government provided services. This includes contracting with or selling to private parties the functions or firms which was before controlled or owned by the government. This word “ privatisation” as an economic policy was pursued for the first time by the Federal Republic of Germany in 1957, when the government eventually sold majority stake of Volkswagen to private investors. The next big move in privatisation came in the 1980s with

Margaret Thatcher’s privatisation of Britain Telecom and Chirac’s privatisation of large banks in France. After we know the meaning of privatisation and when it starts, the following part list some of arguments for and against privatisation:

a. Arguments for Privatisation:

– Incentive effects for management: is one of the most important arguments supporting privatisation. As we know in the public sector there is a missing link between ownership and management control, since the government have a few incentives to ensure that the enterprises they own are well run because of lack of comparisons in state monopolies. Also, the central form of ownership lead the managers in state-owned firms are unwilling to use incentives tied to performance.

On the other hand, we can say, privatisation in this case is a good solution given that the private owner firms are more bureaucratic and they are more concerned to reward the management in much more efficiently in order to compete in the market and maximize profit. However, if the firm performance could be improved under the state ownership through some incentives then the reason for privatisation would be weaker, particularly if privatisation generates costs through the need for regulation.

Since most of privatisation method used in Oman is share issue (selling a percent of company share on the market) and until now there is no 100% privatising of state-owned firms; the real incentive effects in the management of these firms can’t be notice. Most of privatisation process was only in a percentage of the total share and usually the previous management as it’s before and after.

– Market forces more likely to be allowed: privatisation help in creation of suitable conditions for developing a competitive environment in a market economy to benefit from the advantages of competition in order to increase the efficiency of management of assets and production and reduce market prices. In other word, it allow firms to be forced by Market power since it been in the hand of shareholders an important source of finance and in the assessment of consumers in free competition market, which lead the company to improve the quality of products as well as the status of the institution.

A good example of this case in Oman is privatising 30% of General Telecommunication Organization in 2004, as a first stage in privatising the whole Telecomm Sector, and also GTO is the second highest government revenue earner, it will not be easy for the government to let it go. Although this was an important step but it didn’t cause a big impact in the consumer side as a result of natural monopoly since GTO is Oman’s sole provider of paging and Internet services. However, the second and third stages of build up Oman Telecommunications Regulatory Authority and allowing competitors to enter the market such as: Nawras (the Omani Qatari Telecommunications company, 2005) are the most beneficial steps for the consumers since it enable more consumer choice from a number of private suppliers and price reduction.

– Increased share ownership: Privatisation help to brought new companies to the market by increased equity listings on the stock exchange. Many of privatise companies after initial listings, issued additional shares by ways of bonuses, public offerings and rights issues, consequently enlarging the market in terms of share ownership and outstanding shares. In our case about Oman, privatising 49% of Oman Flour Mills, 49% of Oman Cement & 65% of Al-Maha Petroleum Products Marketing Companies etc, all has been added a great value to the share list in Muscat security Market.

– Reduced government interference: almost privatised industries are not suffered from government interference as nationalized one, which are prone to interference from the government usually for political reasons. For example, in Oman making an industry buy supplies from local producers, when that may be more expensive than buying from abroad, in order to encourage domestic production. Add to that, forcing an industry to increase its national staffing to reduce unemployment etc. Although most of these conditions is in the side of public interest and developing the national economy but from investors side are constraints delay their investment.

– Reducing the PSBR & Additional Capital: the idea of privatisation begin from selling state-owned firms to private sector to help reduce country budget deficit, although the idea in itself is not the best as a solution for budget deficit but privatisation lead to less dependence on the treasury for additional capital for investment purposes. In other word, privately held companies can sometimes more easily raise investment capital in the financial markets when such local markets exist and are suitably liquid. A recent example of one privatise company in Oman, is Salalah Mills Co.

authorized and issued share capital consists of 3, 750, 000 shares of RO. 1 each to increase its capital from (7 to 10 million RO) on 31st December 2008.

b. Arguments against Privatisation:

– Public Interest: some sectors for social purposes can't be privatising and run as profit making companies. For fairness and social justice and to protect them from uncertain market and externalities, such as: health care and education.

– PSBR problem: one most likely long run result of privatising most of state-owned firms is increase in public borrowing, since the government will no longer gains the profits.

– Job loss: it's one negative effect of privatised companies in order to keep more money due to profit maximization purpose and budget constraints, unlike the public companies which supported by the government.

– Natural Monopoly: is one of the most common dilemmas exists with privatisation which will not result to true competition, the coming part of this essay focus on this problem.

3. Natural Monopoly:

– What is natural monopoly?

A natural monopoly occurs in an industry where a single firm can produce output or supply services in a market at a lower per unit cost than what two or more firms can, (telephone industry, electricity and water supply are often cited as examples of natural monopolies). These industries relatively face high fixed cost structures; the necessary costs to produce even a small amount are high. In simple natural monopoly is a situation when a firm realize economies of scale in producing the market demand of output at lower average cost than two firms could with smaller scale processes.

The concept of natural monopoly presents a challenging public policy. Despite that the natural monopoly implies that efficiency in production would be better served if a single firm supplies the whole market, in the absence of competition the monopoly holder will be attracted to use his natural monopoly power to maximize the profit, which shows the importance of regulate such natural monopoly industry.

– Why regulate natural monopoly?

There are many motives behind the regulation of natural monopoly and requires various types of regulation. The following part set in brief some reasons of regulating natural monopoly and regulatory processes.

Motives of regulating natural monopoly:

-Allocative Inefficiency: in a competitive market the price is set equal to marginal cost. However, in natural monopoly because of only one supplier available and its incentive to maximize profit he set the price greater than the (MC) which lead to under-allocation of resources, i. e. producing smaller output than competitive markets could and increase the price.

-X-Inefficiency: is a situation when the company fail to produce any specific output at the lowest average cost possible within the existing state of the technology. In that cases the company produce the total output demand but with a higher average cost (avcx&avcx') as illustrated in Figure(1):

Figure1: X-Inefficiency situation

Regulatory processes:

Choosing the most appropriate process of regulatory based in the project relative to the operating conditions and requirements of the concerned sector is the key role of privatisation success. The most common model of incentive regulation is Price-Cap Regulation (RPI-X).

– Price-Cap Regulation (RPI-X): is a model requiring the firm to increase its prices for each year within a given period by no more than the retail price index (RPI) minus a variable factor (X) which is the expected efficiency saving.

The motivation behind this model is the flexibility to provide the firm with the incentive to behave more consistently with regard to the social optimum. On the other hand, the model shows some weaken such as disincentive of changes to X. Also, it requires excessive power of regulatory to diminish the capture problems associated with rate of return regulation.

4. Conclusion:

All over, many developing countries economies privatisation has been an important issue of policies aimed to increase efficiency, quality and promoting competition in public industries. The change from state to private ownership usually supports utilities' incentives to minimize costs and improve performances.

Well designed privatisation policies, can also facilitate the development of competition and increase the effectiveness of regulation, by improving the information available to regulatory bodies, and enhancing the overall transparency of the regulatory process.

Finally, but equally important privatisation experience in Oman shows the advantages of the government as industrial regulator rather than owner and manager. On the other side, the most important disadvantages is natural monopoly, which increase as a result of the small market size of the country as any other developing countries almost depends on the state-owned firms to provide most of the public services.