Box 5.3. Privitization: Can the private sector deliver public goods?


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Privatization—the sale of public assets such as a state-owned railroad or water utility to the private sector—is common worldwide. No services are exempt: banking, electric power provision, oil and gas production, healthcare delivery, water delivery, education, telecommunications, and transportation services are all frequently privatized by national, provincial, and local governments. Although the trend of privatization began in developed countries in the 1980s, today it is prominent in developing countries as well, where natural resources are often the assets targeted for sale. For example, 40 percent of the $44 billion in revenues that developing country governments raised through privatization in 1999 came from the sale of state-owned petroleum, mining, agriculture, and forest assets (World Bank 2001:183,188).

Governments privatize their assets for several reasons. One is to shed state enterprises that are operating at a loss and draining the government’s coffers. Another is the hope that private owners will run the enterprises more efficiently, bringing better service than the state could provide by infusing the enterprise with new capital, improved management practices, and better technologies. However, the decision to privatize can be controversial, particularly when governments propose putting essential services like water delivery and electric power provision into private hands. The worry is that private companies may increase the efficiency of the enterprise, but ignore social objectives in the bargain, such as keeping the cost of water and power affordable, or providing bus service in poor areas.

The theory of privatization

Governments and international financial institutions typically promote privatization based on two arguments. First, theory suggests that public officials—politicians and bureaucrats—lack the incentive to run an enterprise efficiently. They can rely on public bailouts if bankruptcy is imminent. Also, there is no market competition or takeover threat as there would be in a typical business, and the public doesn’t scrutinize performance as shareholders in a public corporation would (Ram Mohan 2001:4865–4866).

Second, public managers often have to balance contradictory objectives. Efficiency may be sacrificed to increase social benefits such as employment, which may then translate into political support. For example, the poor state of the electricity sector in India has
been attributed to public bailouts of bankrupt utilities, political pressure to allow nonpayment of bills, and below-cost electricity prices for politically influential farmer constituencies (Dubash and Rajan 2002:51–71).

Another impetus for privatization is the trend toward decentralization. Privatization proponents frequently conflate the two strategies. In fact, decentralization and privatization have very different effects. While decentralization, done well, can increase public input into local governance, privatization often leads to greater public exclusion from resource decisions, since it shifts ownership—and therefore control—to corporations and other actors that do not have to answer to the public. In the natural resources sector, privatization often incorrectly takes place in the name of decentralization. In Mali, for example, forests are being transferred to local elected authorities—an apparent sign of decentralization. However, these officials are being given the right to sell off the forests, taking them out of the public domain and reducing the public’s future role in managing them (Ribot 1995:21).

Critics and controversy

Critics of privatization question whether its promised efficiency gains are ever realized in practice (Ram Mohan 2001:4870–4871). They also charge that privatizing essential public services such as water and electricity, is fraught with near-insurmountable problems of governance (Hall 2001: 11–16). For example, when politically connected and powerful multinational corporations take over the provision of public services, governments may not be able to enforce competition or appropriately regulate these companies. The result may be higher prices for basic services, a lack of attention to environmental impacts, and a lack of commitment to public goals such as increasing access to water and sanitation services. These, in turn, may evoke a social backlash against privatization.

There are many examples of the controversy that can accompany privatization. Among the most publicized is that of Cochabamba, Bolivia. In 1999, when the city auctioned off its ill-functioning water system as part of this program, it received only a single bid—from a British-led consortium. But the government proceeded with the sale, handing over in the deal not only the water system but also the rights to all the water in the district—including underground water—and guaranteeing a 15 percent annual return on the company’s investment (Finnegan 2002:45).

Taking advantage of these terms, the consortium quickly raised the price it charged for water, in some cases doubling water bills (Finnegan 2002:47). This sparked mass demonstrations in Cochabamba and escalated into confrontations with armed police. As unrest grew, the government eventually revoked the contract (on the grounds that the company had abandoned its concession) and rapidly implemented a new national water law that promised public consultation on rates, and provided protection to small-scale water systems (Finnegan 2002:51).
The Cochabamba example and other problem-ridden experiences in Buenos Aires, Manila, Johannesburg, and other cities have convinced some social advocates that privatizing such basic necessities as water is inherently problematic. These advocates suggest that essential services should not be privatized without greatly improved regulation by the state and participation by citizens to ensure that private firms are accountable to consumers and to the public at large (Kessler 2002:4–6, 8–12).

**Economic benefits?**

On the other side, many economists believe that, judged on economic grounds, privatization’s record looks good. They argue that statistical surveys largely show that it does, in fact, lead to greater efficiency (Megginson and Netter 2001: 345–360). For example, a study in the United Kingdom found that electricity privatization had resulted in a permanent reduction of 5 percent per year in the cost of providing electricity service (Newbery and Pollitt 1997:269).

However, these results are by no means definitive (Ram Mohan 2001:4865). For example, privatization often occurs at the same time as deregulation, and the effects of the two are not easily separated. Economic gains attributed to privatization may just as likely be the results of deregulation and could also reflect other macroeconomic trends, such as general economic expansion.

Most importantly, perhaps, while economists have focused on economic gains, they have not applied equal vigor to understanding whether the efficiency gains they measure are actually distributed equitably among the population (Birdsall and Nellis 2002:3–4). In the United Kingdom, for instance, electricity producers and shareholders captured all the economic gains from privatization, while consumers and the government were net economic losers (Newbery and Pollitt 1997:269). The result of all these factors is a significant gap between the reported economic benefits of privatization and its apparent social costs.

**Environmental implications**

From an environmental perspective, the outcomes of privatization rest heavily on initial negotiations between the government and the private company and particularly on the details of the contract drawn between the two. Inappropriate water privatization contracts, for example, might undermine conservation efforts and reduce attention to water quality. Or they might fail to insist on minimum water flows in rivers and streams that are needed to keep aquatic ecosystems healthy (Gleick et al. 2002:iv, 37–38). Conversely, when environmental considerations are factored in at an early stage, privatization has the potential to promote environmental goals. For instance, through a combination of environmental audits, detailed environmental provisions in contracts, and mandated compliance with existing environmental standards, the environmental performance of steel-making facilities in Mexico and Kazakhstan greatly improved after privatization (Lovei and Gentry 2002:63, 69–70).
While the available evidence is limited, experience from the electricity sector suggests that environmental concerns tend to get short shrift in privatization efforts (Dubash 2002:157). A review of recent sector reforms—which often feature privatization of power production and distribution—revealed that technocrats from energy and finance ministries have dominated the restructuring process in the countries studied. Representatives from environment ministries or civil society groups have had little or no voice in the design process, and opportunities to promote environmental outcomes have been missed. For example, Bulgaria’s international commitment to reduce greenhouse gases was not factored into the country’s electricity reforms, despite the considerable opportunity it had to reduce emissions by providing incentives to upgrade inefficient industrial plants and engage in other energy-saving measures (Doukov et al. 2002:97).

Experience in the electricity sector suggests a more general point about privatization. Economic reforms such as privatization have often arisen in closed processes. In these circumstances, privatization has sometimes been pursued to achieve narrow goals, rather than as a means to a range of public policy objectives including greater efficiency, wider access, better service, and reduced environmental impact. A more open and democratic process of economic governance that allowed for broad debate about the goals of reform would substantially increase the potential for incorporating social and environmental goals into privatization reforms (Dubash 2002:170).