

Current issues in Private sector participation (PSP) in water services

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Abstract

Privatization of public infrastructure became the *mantra* of many development agencies since the late 1980s. Water supply was not an exception and different forms of private sector participation (PSP) in water supply have been experimented. Among the policy circles, privatization became the objective in itself rather than a means of increasing access or helping the poor and increasing the overall performance of the economy. This article examines the results achieved by these experiments. The evidence shows that PSP has mixed results and private sector is not more efficient than the public sector. It also shows that in most cases PSP did not deliver as it was expected. Despite growing failures and increasing public pressure, the article concludes that PSP debate is still alive, but repackaged through different forms.

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Introduction

It is an established fact that performing public utilities infrastructure (water, roads, telecommunications, port, airport, electricity) leads to better economic performance and poverty reduction. In order to better develop their infrastructure countries have different models in place in terms of the degree of private-public sector involvement for such services. Whereas there seems to be general consensus among policy makers and experts for the State to disengage from the telecommunications and electricity sector, there is disagreement regarding the State's role in the provision and supply of water services. Public utilities infrastructure, especially water, is unavoidably social in nature and draws such political emotions, like no other issue. Privatization and its varieties like PSP² in water services is based on the neo-liberal strategies.

The neo-liberal strategies mainly emphasizes on the importance of the market, fiscal discipline, trade, investment and financial liberalization, deregulation, decentralization, privatization and a reduced role of state (Robison and Hewison 2005, p. 185). Certain other strategies such as a limited welfare state, flexible labour market, and restrictive fiscal policies have been given priority over social policies. These strategies are also referred to as the *Washington Consensus*³. PSP was introduced in developing countries as the linchpin of the Washington Consensus, which was proposed mainly on the competition and efficiency argument. It was argued that PSP will bring in the much needed investment, increase access, and improve quality of the water supply. Historically, most water system in developed European countries was initiated by the private sector. Today it is the public system which provides water & sanitation in most of the countries. It is estimated that over 90% of the world's population is currently supplied by the public sector. The funding generally comes from taxation, borrowing and user fees.

After over 15 years of experimentation with various forms of PSP in the water supply, it is time to take stock of the results. This article will evaluate the lessons learnt from 15 years of PSP in the water supply based on empirical evidence and literature review. It will particularly investigate the impact of PSP on access and impact on the poor. In doing so, this article also aims at presenting a state of the art and current issues facing the water supply in developing countries. Evidence gathered shows that PSP has not achieved the desired results, especially in the developing countries and there is increasing failure and difficulties. Despite growing failures and increasing public pressure, the article concludes that PSP debate is still alive, but repackaged through different forms such as public-private partnerships (PPP).

² Private sector in this article will imply mainly multinational firms involved in the water supply which has commercial objective of making profit.

³ John Williamson (1994) was the first to coin this term, referring to the orthodox economic policies promoted by the US Treasury, the International Financial Institutions, IMF and the World Bank (all based in Washington). It should be reminded that he argued that neo-liberalism should not be synonym for Washington Consensus.

Current context

Private sector participation (PSP) in water is one of the most controversial debates of the development discourse today. On one side are the proponents who argue that since government has failed in providing access to everyone, private sector can solve this problem by using the market principles. Those who advocate the involvement of private sector in water supply (development agencies like the World Bank, international financial institutions, bilateral donors, professional associations and some scholars) argue that private sector will improve efficiency, increase extension of service, bring in more investments, and will relieve governments from budget deficits (World Bank 2004a)⁴. It has been argued that because of lack of funding to improve the water infrastructure, developing countries are caught into the “*low-level equilibrium*”, implying low operational efficiency leads to low quality service (Anwander and Ozuna 2002). In order to break this circle PSP is the solution.

On the other side of the spectrum are those who consider that water is a common good and should not be in the hands of the private sector. They argue that since water is unlike any other resource and because of the fact that water is the essence of life itself, it should *not* be treated like a commodity based on market principles. The private sector cannot apply a just criteria for this basic need. Access to water for everyone then becomes a human right and it is the State’s obligation to provide this vital resource to everyone. This notion of human right goes back to the Enlightenment era where Hobbes (1588-1679) and Locke (1632-1704) had argued that it is the obligation of the State to uphold, protect, promote and enforce rights. But does the State have the capacity to deliver this service to everyone?

Each side has a passionate argument, whether water should be commodified based on market principles or whether water is a social good therefore in the public hands. And then there is another group who are caught in between these two opposing views. This group thinks that solutions can be found by considering water as an economic good and a human right at the same right. The truth may be found somewhere here. It is important to set the context in which these debates take place.

The neo-liberal⁵ argument, which is based on free market principles to solve the problem of water, has been gaining grounds since the 1980s. This neo-liberal position was given life during the Thatcher and Reagan era (1980s), which was later propelled through the so-called *Washington Consensus* argued that PSP in public utilities should be a preferred policy over state involvement. After the experience of privatizing water utilities in the UK and other developed countries, PSP was prescribed to developing countries.

⁴ World Bank. (2004a). Water Resources Sector Strategy: Strategic directions for World Bank engagement, IBRD/World Bank, Washington DC.

⁵ The neo-liberal position is based on free trade in free and unrestricted market and private property. It should be noted that arguments in favour of private sector must originate from Adam Smith (1723-1790), who preferred that the private sector should be involved in business and not that State. Later, Hayek (1899-1992) took the relay from Smith’s liberalism and gave it a new intellectual momentum, which became neo-liberalism. However, one small point is that Adam Smith recognized the importance of water and he has reservations that if the private sector was involved in the provision of water, this could lead to unwarranted risks (Smith 1976:33).

The critics of this neo-liberal have generally focused their efforts in demonizing the private sector and the profit seeking motives of large corporations. The private sector responded by proposing (or accepting) certain forms of *corporate social responsibility*. The major opposition which comes from the *rights-based approaches* of water, has been relatively weak in substance and heavy in rhetoric. In general, three groups of critics of neo-liberals argument in water supply can be identified for analytical purpose:

- Academics, mainly economists who do not question the PSP *per se*, but criticize the sequencing of the privatization reforms, such as Joseph Stiglitz, Paul Krugman, David Parker, Colin Kirkpatrick, ... This group also calls for better regulation of the PSP.
- Those who believe that the public sector can do the job better if given the resources, such as the Public Service International (which is the global federation of public sector unions), David Hall from Public Services International Research Unit, Transnational Institute,...
- Those who criticize it on ideological grounds, which comprises mainly of NGOs such as WaterAid, Polaris Institute, Council of Canadians, World Development Movement, Public Citizen, and some academics.

On the other side, the pro-privatization group is well organized. There are a few pro-privatization international lobby groups such as the World Water Council, World Business Council for Sustainable Development, International Chamber of Commerce, Business Action for Water, World Economic Forum.

Equity in and access to water services

Issues surrounding water and poverty have now been recognized as something crucial by the international community as evidenced by the Millennium Development Goals (MDG). Target 10 of MDG aims to “*Halve by 2015 the proportion of people without sustainable access to safe drinking water and basic sanitation.*” According to various estimates compiled by the World Water Council (2006a), around 10 billion USD per year would be needed to deliver basic water and sanitation to the people who do not have currently access. In other words, the current levels of investments would have to be doubled in order to achieve the target 10 of MDGs (i.e. to halve by 2015 the proportion of people without sustainable access to safe drinking and basic sanitation).

All developed economies provide some sort of income support to help the poor afford water supply (OECD 2003a, p. 34). In addition, these countries have also put in place mechanism to help the general population and they have policies targeted to selected groups, such as the poor, large families, older people. These measures include VAT reduction, progressive social tariffs, eliminating disconnections, eliminating annual fixed fees, targeted assistance to poor people such as free water up to a defined volume, forgiveness in arrears, and grants. However, according to OECD (2003a, p. 34) it is argued that the impact of such social policies is limited since the aid is relatively small and the level of poverty minimal in these countries. In another publication OECD (2003b, p. 18) argues that such social policies in tariffs contribute to economic efficiency, resource conservation and equity goals. Such social policies

would be more appropriate in developing countries where the level of poverty and inequality is high.

Linked to the equity issue is the question of *access*. Over 1.1 billion do not have access to safe drinking water worldwide and over 2.6 billion do not have access to sanitation services. On the positive side, 83% of the world's population have access to improved drinking water (WHO and UNICEF 2004). Those who are not connected to the water supply system, often resort to purchasing water from independent providers, often at excessive high prices. And those who cannot afford it, use unsafe polluted water for consumption and there are over 1 billion of them. WHO estimates that around 2 million people die every year due to diarrhoeal diseases (90% of them are children under 5), which places diarrhoeal disease as the 6th highest burden of disease on a global scale (WHO 2003, p. 1). Around 4,000 children die each day because of water born diseases. And this leads to a vicious cycle for the billions of people who are locked in a cycle of poverty and disease (WHO 2005). In other words, poverty leads to deprivation, which leads to consuming unsafe water, which leads to diseases, and inability to work, leading to increased poverty. This poverty trap can clearly be overcome by having access to safe water.

Going back to our initial concern about PSP in water, what is the premise of this argument? How did it all start? Its important to take a look at what the theory about privatization says.

Why privatize? Theory of privatization

Privatization is a political strategy which creates new rules and new roles between the State, market, and the civil society. According to Savas (1987), there are four types of privatization: ideological (less government), populist (better society), pragmatic (effective solutions), and commercial (more business).

As mentioned above, it is argued that private ownership is more efficient in delivering services compared to the State. In other words, privatization takes place to increase economic efficiency (Yarrow 1999, 162). According to Sheshinski and Lopez-Calva (2003, p. 430), there are four major objectives of privatization:

- To achieve higher allocative and productive efficiency
- To strengthen the role of private sector in the economy
- To improve the public sector's financial position
- To free resources for allocation in other important sectors such as social policy.

The theory of privatization is an offshoot of the broader issue of ownership and the role of government and regulation (Megginson and Netter 2001, p. 329). It is also argued that "*divestiture and other related reforms can substantially improve economic performance...*" (Yarrow 1999, p. 157). Adam Smith also preferred that economic activities should be in the hands of the private sector, which will also help the State in having a better financial position (Sheshinski and Lopez-Calva 2003, p. 432). The initial assumptions were that there are no externalities, not a public good, the market is not monopolistic, and no asymmetry of information (Megginson and Netter 2001, p. 329). In other words, privatization becomes less compelling in these circumstances. This is exactly the case for water supply, which presents all these exceptions and is

considered a *natural monopoly* (this concept was introduced by John Stuart Mill (1806-1873)). With all these exception from a theoretical perspective, *is* the argument that PSP in water supply will increase investment and efficiency becomes still justified?

According to Balance & Taylor (2005, p. 12) the natural monopoly of water industry is no different than electricity transmission and distribution. However, a key difference is that upstream production and distribution does not exist in the water industry since a customer can be supplied through using other supply alternatives such as borehole, large individual reservoirs. In addition to the high capital intensity, the water industry also has high sunk costs. Since water is affected by the weather and because it depends on the nature, long term storage options becomes problematic, especially in times of draughts. Since water does not have substitute, and is directly linked to public health and environmental concerns, affordability is one of the key concerns. All this leads us to show that the water industry is an unusual business and does not fit into standard economic theory regarding competition. It is argued by Balance & Taylor (2005, p. 18) that even if competition were possible, the benefits of such competition would be minimal.

Poverty and privatization literature

Studies dealing with efficiency of private versus public ownership reveal that there is ambiguity and there is no clear relationship. A decade ago, privatization was “heralded as an elixir that would rejuvenate lethargic industries” and revive stagnating economies (Kessides 2005, p. 86). Today, there is an outright rejection of privatization all over the world mainly because of price hikes and affordability issues, access, redundancies, and in some cases exorbitant profits for firms and corruption.

Studies on privatization can be divided into two groups: one that consists mainly of econometrical and statistical work and the other consisting mainly of case studies⁶. The econometrical work generally demonstrates that privatization (measured in terms of ownership) had a positive impact on the economic performance, especially from the micro-economics perspective. However, cross-country econometrical studies have been inconclusive. On the other side, the case studies demonstrate that there have been some improvements (especially productivity and profit) but the process is much more complex and the benefits are not automatic.

In general, both methods show that privatization contributes to improving performance at the firm level and that privatization alone is insufficient to increase economic performance. Ownership itself does not mean better performance. It is also not clear whether the private sector has improved coverage and access for the poor sections of the community. In most of the econometric studies, it is demonstrated that other structural reforms such as regulation plays a crucial role (Parker and Kirkpatrick, 2005). One important contribution of the case studies approach demonstrates that social and institutional context are more important for the privatization to be successful.

⁶ For more details see Parker D., and Kirkpatrick, C. (2005).

Some selective academic literature will be used to analyze issues of poverty and privatization. Benitez et al (2003) have found that all categories of the population benefit from access and coverage improvements, efficiency and quality for the case of Argentina. In addition, it is the poor who benefit the most from access and productivity increase. McKenzie and Mookherjee (2003, p. 212) demonstrate that there is no clear evidence of price increase and increase in poverty in countries that had PSP, especially for the case of Latin America. However they do find negative impact on jobs losses, which according to them were relatively low compared to the nation wide employment. Bayliss (2002) on the contrary, although anecdotal, emphasizes that privatization has had a negative impact on the poor in terms of job loss, decrease in income and reduced access to basic services. However, to get a clearer picture, privatization should be assessed in its economic, historical and social context (p. 619). Birdsall and Nellis (2003) show that privatization has indeed aggravated the asset distribution and income, and have increased inequality. They also show that access increases and in most cases together with price increase. With a rigorous econometrical method, Galiani et al. (2005) demonstrate for the case of Argentina that not only privatised firms were more efficient, invested more and provided better service, but the access also increased in privatised areas. In addition, they also show that welfare increases more with PSP since for same levels of connection, child mortality decreased more in PSP compared to that of the public sector and that it was the poor who benefited the most. However, they are now able to explain the causal mechanism of this increase. Mulreany et al (2006) demonstrate that privatization is not a good policy option for improving access and public health. On a more philosophical level, they argue that privatization prefers the “non-poor” and is profit-motivated and therefore it is not an appropriate policy on equity and social justice ground. In addition, through privatization of water services, the government distances itself from providing one of the essential basic needs to its people.

The World Bank itself has also done several studies on the issue of access and affordability regarding PSP in infrastructure services. One such study recognizes that PSP in the infrastructure did not take into account the sensitive social issues and as a result did not have any specific social policy framework (Foster 2004, p. 5). Estache et al. (2001, p. 1180) also highlight that PSP produces distributional effects, which has been neglected. They also show that the relation between the poor and PSP is complex and ambiguous. However, they argue that the social issues of PSP should be tackled within the general framework of the poverty alleviations programmes and not directly within the utility reforms (Estache et al. 2002, p. 107). PSP does not necessarily improve coverage and there is no evidence that the poor suffer as a result of private sector participation in the water supply (Clarke et al. 2004). In another study Estache et al. (2002, p. 13) demonstrate that although the total welfare increases as a result of PSP, the gains are not shared with the poor. Estache & et al. (2005) demonstrate that there appears to be no difference between private and public operation in terms of efficiency performance. Another World Bank publication recognizes that more in-depth analysis are needed to evaluate the impact of private sector participation on the poor (Kessides 2004, p. 15). In a joint publication, IMF and World (2004, p. 3) recognize that PSP is not necessarily superior than the public sector in the provision of water services.

Access and affordability

There is very little empirical work done regarding the effects of PSP in water supply in developing countries. In *cross country* analysis, there are several studies regarding utility privatization and coverage, but there are only a few on PSP in water supply. In general, the results are inconclusive. One such study worth mentioning is that of Clarke et al. (2004). They are not able to show whether private sector was responsible for increasing coverage, since coverage also increased in areas with public sector management. As for the connection rates for the poor, there is no evidence that this increase is associated with the private sector.

Therefore, these improvements do not reflect on the welfare of consumers. In most case studies, it was found that prices increased after the PSP. Raising water prices is counterproductive and increases inequality, taking into account the low level of prices and income elasticities for water. In other words, water consumption varies very little with income since water needs of each person are similar in terms of drinking, hygiene, sanitation, etc. So they will have to pay no matter how high the prices would be. For example, according to Smets (2004, p. 11) water consumption in Europe varies around 75% between the first and last income deciles, whereas income varies around 600%.

There are very few empirical studies done on the *affordability* issues and PSP in water supply in developing countries. It is assumed that the weight (proportion of income) of water bills will be higher for lower income people compared to that of richer ones. For example, in developed countries each household pays between 0.5-2% (1.3 in Germany and Netherlands, 1.2 in France) of their income for water bills (Smets 2004, p. 19). Those who earn the minimum salary in France and Germany pay between 3.4-5.2% of their income. In the UK, the poorest 1% of households pay over 10% of their income in water. In Mexico the poorest pay 5.2% of their income for water, whereas the rich pay only 0.8% (Smets 2004, p. 133). According to international practices, this should not go beyond 5% of a household's income. In some developed countries, a household should not pay more than 3 times the median water bills (3.9 in UK, and 3.6 in France).

The topic of privatization of public services is been well researched. Generally, there is agreement that privatization leads to an increase in micro-economics performance (profitability of firms, productivity increase and efficiency of firms). However, how this impacts the broader economy and how this helps in reducing poverty is still not

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