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## **Public sector privatization - legal framework**

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# PUBLIC SECTOR PRIVATIZATION – LEGAL FRAMEWORK

## 1. INTRODUCTION

With the accession of ex socialistic countries in EU the problem of public sector privatization became the most popular and at the same times the most important political question. Privatization becomes at the end of the 20<sup>th</sup> century the magical word, which will resolve all the problems and incapability in public sector. We're talking about the sector which functioned in monopole framework with all the good and the bad sides of such system. It was the sector which was used and sometimes abused by the state to promote social, political and employment goals. On the other side, distribution, quality and quantity of public goods and services was defined by the state. So the consumers had no choice – their only choice was to use or not use such product. In some countries (like in ex SFRY) also the infrastructure for public services or goods was built with private money (direct or indirect investments)<sup>1</sup> and become the social or state ownership with no remuneration. Within public sector we could speak also about the problem of authority privatization, but it's a topic, which requires separate analyzes. The intention of this contribution is to show the problems of privatization on the supplier and on the demand side.

## 2. TERMINOLOGICAL QUESTION

Regarding this contribution first the institute of public sector privatization should be defined. In everyday life such term means different things:

- privatization of some activities within the public services (outsourcing);
- public service management privatization – service still remains public but the private sector takes responsibility for the management and sometimes also for the execution;
- privatization of assets needed for public services;
- public service privatization – service is no longer public but becomes market activity with all the negative aspects of market and legislative failures.

Although also the first three types of privatization aren't without the problems, the focus in this contribution is on the last abovementioned privatization type. It's the type which is less economically and legally developed and on which there is the most pressure from EU.<sup>2</sup> It's also the privatization type, which yet<sup>3</sup> and also in future<sup>4</sup> will cause the big problem for the state and for the users of such services and goods. Special consideration and political discussion deserves also so called hidden (wild)

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<sup>1</sup> Cases of direct investment are when the consumer has paid all the costs for material and work to the house counter (e.g. water pipes, phone wires, gas pipes, etc.). Cases of indirect investments represents two different modules:

- building costs for the infrastructure was paid in each bill under the "payment for infrastructure development" (e.g. wasted water management);
- citizens self contribution system voted through the referendum and executed on each month salary for the voted time and voted percentage (e.g. hospitals, roads).

<sup>2</sup> The core sectors are: railways, energy and telecommunications.

<sup>3</sup> E.g. in UK, USA.

<sup>4</sup> Especially in ex socialistic countries.

privatization. Such process represents on long term danger of lowering accession to the public services and goods.<sup>5</sup>

### 3. SUPPLIER SIDE

On the supplier side privatization can cause problems so to existing suppliers as o new incomers. Privatization of existing suppliers means two phase privatization:

- privatization of state owned company – connected with the problems of fair price, privatization method, management change, etc.;
- public service privatization – connected with the problem of privatization degree, organizing the remaining public service, overregulation etc.

In both two stages of privatization process existing suppliers live in certain insecurity what may cause the loss of key personal and key contractors. So the longer will be the both stages greater loose will suffer the existing suppliers. It's merely political question to what extent the existing suppliers will be present on the market and how strong will be their market position.

Although the intention of public service privatization is to promote competition and to make possible entry of the new suppliers, in practice such processes in fact can cause the strongest market position of existing suppliers and bigger entry barrier. Such final result could depend on different reasons.

Hidden legislative barrier is one of most dangerous and most popular. This barrier is result of existing suppliers past influence on legislation. In case where public administration didn't have enough knowledge how to regulate certain question, preparing drafts was delegated to public service supplier. In such case regulations fit to the existing suppliers either in technical or in personal or in organizational demands. So new suppliers have the choice either to adapt whole structure to existing regulation or not to enter in such market. Danger of such barrier is yet bigger because all the privatization process is normally run with the hidden help and consent of existing suppliers (result of lack of certain professionals, strong lobbies, financial connections between political parties and existing suppliers, etc.). Such barriers are dangerous for new suppliers because even if legislative demands are not constitutional it take time before the case is closed.<sup>6</sup> So the new supplier can't start to operate or can't operate fully during such procedure.<sup>7</sup>

Second factor can be the request that the supplier must have the certain infrastructure before he could operate. So the existing supplier has the advantage of existing and developed infrastructure what was mostly financed by the state or by the users. The new suppliers are in a subordinate position – they can start only with the basic service

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<sup>5</sup> Such case could be the public service which is paid by the budget but user can with additional payment get better or faster service. Public service provider, awarded for the better income, at the end tends to provide service only to the consumers ready to pay for better or faster service. The "ordinary" consumer tends to be on the waiting list. If this waiting time is too long, than we can't talk about the public service any more.

<sup>6</sup> Such cases can take 5 or 6 years before the constitutional or similar court reaches the decision.

<sup>7</sup> Existing supplier can start with intensive marketing and so gain new users.

and with a certain time difference. In most ex socialist countries this can really present a big problem considering complicated and long procedure to obtain the building permissions for infrastructure. On the other hand there arises a practical question why to permit building new infrastructure if the existing is not fully exploited.<sup>8</sup>

Third factor can be the changing legislation. Investors seek the stabile economic environment. If the state change regulations too often, than investors are dealing with high legislation risk. On the other hand rapid changing regulations constitute also a doubt in the state of law regarding the capability of law enforcement.<sup>9</sup> Existing suppliers usually have the strong lobby to promote favorite legislative results and know – how to survive in rapid changed legislative systems. Sometimes this works out with the services of friendship to the state.<sup>10</sup>

Fourth factor can be the hidden privatization. In such cases the employees of the public sector provider during the working time make the publicity for their after work activity. So such providers don't have to spend extra money on publicity. On the other hand there is users' perception of personal injury described in next part. This is even more important in the sectors where publicity is restricted or prohibited.<sup>11</sup>

#### 4. DEMAND SIDE

Also on demand side are various factors which in practice work contra privatization and, by the end of a day, cause even bigger monopole position of existing supplier. Even more, sometimes the privatization could for the uses have also the adverse effect. In this part I examined some of these factors.

The most important factor is apathy. If users have lived in the belief that nothing can be changed or improved for last 50 or 60 years, than is hard to change their mentality. For the users could be and normally is a problem to build internal decision system to choose the best solution. Further it could be a problem to force the users to make decisions on the fields on which for the whole users' life the state decided. Users might not be prepared to take decisions and responsibilities for such decisions. It's easier that someone else takes such life time decisions.<sup>12</sup>

Second factor is expectation. Public service prior the privatization sets to the users certain standards and needs. This can be even greater problem on the fields where the publicity is restricted or even prohibited. Why should the user go to the doctor in another town, if earlier it had in his town? How should the user valuate the quality of

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<sup>8</sup> This is the case of building the parallel optical wires networks in the USA. Most of these wires are now dark and unused. So the cost of used wires is ascending on the account of unused but built wires. So instead of falling costs we're dealing with ascending costs.

<sup>9</sup> This is the case of Republic of Slovenia where the legislation in last 18 years was changed 5 times (once in almost four years).

<sup>10</sup> For example free studies of certain problem, free draft legislation, free education of civil servants on certain questions, etc.

<sup>11</sup> We can talk about the cases of unfair competition what is in practice hard to prove.

<sup>12</sup> Such cases are new pension funds in ex socialistic countries. Basic question is why should I decide which fund is safe for my pension regarding the problems of such private funds in USA (i.e. Enron case).

medical service? Why should the user pay service which was till yesterday free? Changing user's behavior is hard and it takes time.<sup>13</sup> This factor becomes even more important in cases when the privatization is only partial.<sup>14</sup> There is a doubt whether the payment for privatized part is really needed and that outcome is worth the given payment. On the other hand, there is users' silent perception, that the proposed privatized service has only intention to make profit to the service provider and not really to improve service. This perception is justified in case when politicians convince users in high quality of non – privatized public service.<sup>15</sup> And yet, why user should pay extra for something what has already paid by taxes.

Third factor is the cost of change for each user. So the visible and quantificated costs<sup>16</sup> as invisible and subjective costs<sup>17</sup> should be taken in consideration. In public services subjective costs are many times more important that visible (real) costs. More users' personal involvement for change is needed; less possibility is to change the supplier. More equal offers from the suppliers, less possibility is to change the supplier.

Fourth factor is lack of knowledge. Supplier change for ignorant user is connected with great risk in case that legislation doesn't cover all the possible situations.<sup>18</sup> For the user such change is connected with the possibility of double payment, risk of bad service or even with the risk to remain without the service in crucial situation.<sup>19</sup> So remaining to existing supplier minimizes such risks.

Fifth factor is the perception of personal injury in cases of personal public services.<sup>20</sup> If the part of service is privatized and the public service provider covers also the privatized part, users are likely to use the existent provider also for privatized part of service. The most usual thinking is that the existent provider could be reasonably offended in the case of using other provider for the privatized part of service and that the public service will be in such case of lower quality when needed.

## 5. POSSIBLE SOLUTIONS

The entire possible solutions base on the presumption that the state has real will to make the privatization of certain public service. Otherwise privatization doesn't have economic and political sense. On the other hand goal of privatization is to provide better and/or cheaper services.

Dealing with privatization of public service requires high degree of knowledge and political consensus. First question is to decide what to privatize and to what extent. In

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<sup>13</sup> E.g. people takes natural to find the good and cheap mechanic (even outside the place they live) but is not natural to seek for good medical service in other town,

<sup>14</sup> In such cases users will maybe interested only in non privatized services, because they aren't willing to spend their own money on certain goods or services (e.g. users don't pay for better materials).

<sup>15</sup> Why should the user pay for optical wires if classical wires are covering all his/her needs?

<sup>16</sup> For example cost for new mobile when changing the operator.

<sup>17</sup> For example cost of annoyance to inform all friends about new number.

<sup>18</sup> What is not the case in privatized public services.

<sup>19</sup> Unprotected consumers in the VEGA case in Republic of Slovenia. Definition of low water as vis major in energy supply contract.

<sup>20</sup> Case of medical service or

ex socialistic countries daily policy is often under the pressure of partial information.<sup>21</sup> By my opinion only the services which could be missed for some time or have the equal substitutes can be privatized. Then the strong legal structure should be build for the cases when the market failure happens. The legislation shall provide effective mechanisms for the state intervention in the case that providers in privatized sector start to abuse their position.<sup>22</sup> There should be enough quality information so that user can take a suitable decision and with established free change of supplier with no cost. And to prevent the unfair competition, in sectors where only partial privatization was introduced, both parts should be organizationally and legally separated.

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<sup>21</sup> E.g. in the begging of 1991 in Republic of Slovenia was a pressure to privatize analogue telephony. As a reference country was given the Netherlands. Deeper analysis shoved that the Dutch privatization covered only the selling of telephones.

<sup>22</sup> Here the abuse of dominant position is not meant. What is meant, are the cases similar to the California energy gloomy.