

Objective of study:

This study analyzes if corporatization of public enterprises reduces political interference. Similar to privatization, corporatization shifts decision rights from politicians to managers, but ownership remains public.

The paper tests this hypothesis using a sample of the largest Austrian water providers from 1992 to 2006, comparing inhouse provision and corporatized firms.

Primary results:

We show that political considerations are an important determinant of water prices: water prices are lower before elections, under left wing governments, and when political competition is strong. These factors are, however, not present or severely mitigated when public firms have been corporatized.

Data:

- Data on municipal water prices for the largest 74 Austrian municipalities between 1992 and 2006.

- Organizational data on whether municipalities use inhouse provision or have corporatized the public enterprise. Roughly one third of municipalities have corporatized their water provision.

- Political data on election dates, the ideology of the government and the seat distribution in the municipal council.

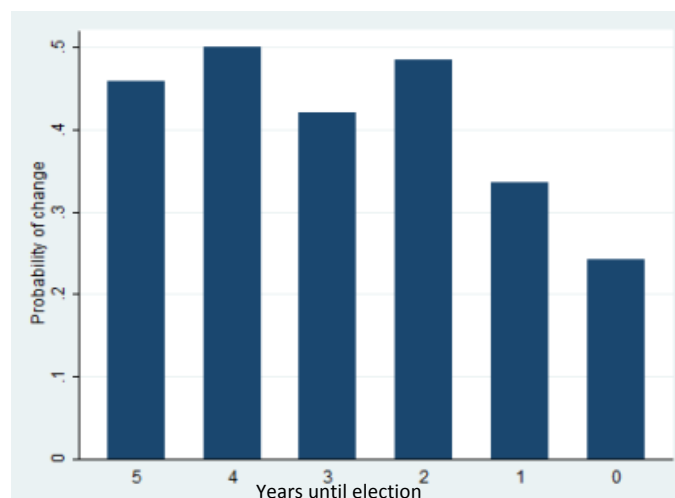
THE POLITICS OF WATER PRICES

That politicians use tax and expenditure to increase their chances of re-election is well established in political economy research. Regarding public enterprises in particular, researchers have analyzed if prices for public services (user charges), which in contrast to taxes should typically be closely connected to cost or a certain degree of cost recovery, exhibit similar political patterns.

A number of important findings arise from this literature, generally confirming the political dimension of water prices with respect to ideological and opportunistic behavior. For instance for developing countries, government opportunism can lead to so-called low level equilibria, characterized by low prices and low quality services. In particular the time horizon of the government, which is mainly determined by election dates, the degree of political competition, and the need to satisfy key constituencies, seems to be detrimental.

Such patterns, however, are not limited to developing countries but are also readily observed in developed democracies. As studies from Spain or Canada show, tariff-setting decisions appear to be made on the basis of political considerations and ideology rather than economic rationality and cost recovery objectives.

In this study, already the descriptive statistics show that political considerations are highly important for water tariff decisions in Austria. As displayed in the Figure below, the probability of a price increase is substantially lower before an election (year 0).



CORPORATIZATION OF PUBLIC ENTERPRISES

In corporatized public enterprises, the government retains ownership but control rights over business decisions are handed over from politicians to managers. As a matter of fact, organizations with these features are not uncommon in public service and infrastructure provision - especially in Europe, where Dexia (2004) estimates a total number of 16,000 corporatized local public enterprises to be present in public service provision. Moreover, although the concept of corporatization is not new, the increased use of separate, legally autonomous agencies represents one of the major trends in public service provision.

The main objective of this study is to analyze if the political interference in water prices varies between inhouse provision and corporatized public enterprises. We would typically expect political factors to be less relevant in corporatized firms, because decision rights are no longer in the hands of politicians but have been transferred to the firm's management:

Hypothesis: Transferring control rights over prices from a politician to a public firm manager leads to a decrease in politically motivated price setting.

METHODOLOGY

Testing the research hypothesis requires two pieces of evidence. First, water prices need to be influenced by political motives when provided in-house. For instance, when politicians have control rights we would expect to find an electoral cycle in prices. Second, if control rights are shifted from politicians to a corporatized firm, the political patterns in water prices should be reduced.

$$price_{it} = corp_{it}\gamma + X_{it}\beta + corp_{it}(X_{it} - X_i)\delta + \epsilon_{it}$$

This model basically tests if the political factors (represented by X) have a different effect on water prices when a firm is corporatized (indicated by corp). The difference is captured by the coefficients in δ , which test if on average the political factors have the same impact on water prices.

A potential problem with this model is that there are omitted variables which affect both water prices in a municipality as well as the decision to corporatize. If, for instance, larger municipalities have lower prices because of economies of scale and they also use corporatized firms more often than small villages, our results will be biased and do not reflect a causal effect of corporatization on water prices.

To deal with this problem we include a number of municipal characteristics and fixed effects, which will capture time constant differences between municipalities such as size, topography, climate conditions. In addition, we use an instrumental variable approach in which we explain the decision to corporatize by municipal debt and whether other public services have been corporatized.

Interpretation of results

The regression models produce coefficients that measure the impact of each variable on the water price.

Importantly, this allows us to assess the effect of politics on water prices, while at the same time controlling for a number of municipal characteristics.

In this respect the municipality fixed effects help us to take time constant differences between municipalities into account. As a consequence, the model no longer compares different municipalities but analyzes how water prices react to changes within the same municipality.

To consider also the possibility that there are unobserved factors that vary over time, we use an instrumental variable approach. We argue that municipal debt and the fact that other services were corporatized represent exogenous variation in 'corp' and therefore help us to obtain a causal effect.

To know more

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An earlier version of the article is downloadable under the URL: <http://chaire-eppp.org/node/596>

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MAIN RESULTS AND CONCLUSION

Our results show that:

- Water prices are lower before elections and if political competition is intense. Moreover, municipalities under left wing governments have on average lower water prices. These findings confirm that water prices are strongly influenced by political considerations.
- Regarding the effect of corporatization, we find that while on average water prices are the same as under inhouse provision, the political factors are no longer relevant to explain pricing behavior. This finding suggests that corporatization curbs political interference in water prices.
- Sensitivity tests show that the effects depend slightly on the particular type of corporatization. While both water associations and government corporations lead to less political influence, the outcome is not exactly the same.

This paper shows that corporatization affects the price setting of water providers in Austria. While the findings of this paper are certainly somewhat specific to the Austrian institutional framework, it supports the general notion that institutional changes can help to reduce political opportunism. In this respect, a number of earlier studies has primarily stressed the role of privatization for successful public sector reform. But given that privatization is often politically infeasible and its consequences in terms of social welfare unclear, it is an important insight that other, less controversial, institutional alternatives exist.

To conclude, while a part of the existing research is somewhat pessimistic about the potential of 'softer' public sector reforms such as corporatization, this study is supportive of more recent research that stresses the potential of hybrid forms of governance, between state and market. The loss of political accountability is certainly lower under corporatization and in markets where competition is hard to implement, one may achieve similar outcomes to privatization, if the institutional design is chosen appropriately.