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CAN PRIVATISATION AND COMMERCIALISATION OF PUBLIC SERVICES HELP ACHIEVE THE MDGs?[*] AN ASSESSMENT

Kate Bayliss[**] *and* Tim Kessler[***]

ABSTRACT

Basic services are essential to reducing poverty and improving quality of life. This working paper focuses on health, education, energy and water. These services contribute to achieving the Millennium Development Goals, as well as being goals in themselves. Over the past twenty years or so, the way in which these services are provided has been subject to considerable policy debate. There has been widespread questioning of the ability of the public sector to effectively deliver such services. Largely as a result, market-oriented solutions have been promoted as a means to overcome apparent constraints posed by state-provided services.

Notwithstanding the weaknesses of state provision in many countries and localities, this working paper argues that reliance on private sector provision will fail to address the central challenges of public sector delivery. Furthermore, the process of privatisation creates an incentive framework that undermines, rather than strengthens, the accountability and capacity of the State to provide accessible and affordable services. In addition, the paper argues that the adoption of full cost recovery policies can seriously threaten achievement of the MDGs. This position does not constitute a blanket statement against private sector participation in public services or against user fees. Rather, it maintains that market-led policies fail to contribute to the MDGs and often reduce the likelihood of achieving them. Strengthening the State in assuming central responsibility for providing essential public services will help correct these setbacks.

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1 INTRODUCTION

At a meeting of the United Nations (UN) in September 2000, all 189 Member States of the United Nations adopted the Millennium Declaration. Of these, 147 were represented directly by their head of state. The declaration committed its signatories to promote a series of goals for poverty reduction to be achieved by 2015 (UN Millennium Declaration 2000) (see Box 1). These Millennium Development Goals (MDGs) are time-bound, quantified targets for addressing the many dimensions of extreme poverty (such as income, shelter, health and education) while promoting gender equality and environmental sustainability. Furthermore, some of these goals, such as access to water and shelter, can be considered to be fundamental human rights. Five years later, at the UN summit in 2005, government leaders reaffirmed their commitment to the goals.

Unfortunately, there has been limited progress towards achieving them. The 2005 *Social Watch Report*, which monitors progress on poverty reduction goals, concludes that if current trends continue, the MDGs will not be achieved by 2015. Aid agencies tend to be more optimistic. However, they admit, for example, that if the goal of halving extreme income poverty is achieved, it will be almost entirely due to advances in Asia.[1] For sub-Saharan African countries, in particular, the MDGs seem like a fading dream. By the World Bank's estimate, the average daily income of Africans earning less than one dollar per day dropped from 64 cents in 1981 to 60 cents in 2001 (*World Development Indicators* 2005).

1.1 SHIFTING THE DEBATE

This working paper examines the impact of market-oriented reform policies on the delivery of basic services. There is consensus that achieving the MDGs will require efficient and equitable delivery of basic public services, especially water, electricity, health care and education. The debate is over the choice of policies. Privatisation and commercialisation gained popularity during the 1990s as the way to overcome the perceived deficiencies of the State sector in the delivery of basic services. In the last few years, some of the difficulties with such policies have been acknowledged even by those that most supported reforms, particularly for privatisation. Today the main controversy is not so much over whether market-oriented approaches entail risks: they do. Rather, it is whether governments should invest in improving traditional public sector service delivery, or establish an institutional framework that reduces the risks of opting for privatisation and commercialisation.

Two premises drive the following analysis. First, *the debate over public service reform needs to be focused on poverty reduction*. Emphasising this does not imply a rejection of the principles of efficiency and fiscal discipline that until recently have dominated reform proposals. Nor is it necessary to categorically reject either user fees or private sector participation. However, as case after case has shown, service providers can become more profitable, governments can save money, and the quality of existing services can improve – without poor people increasing their access to or sharing the benefits of these advances.

The second premise of this paper is that achieving poverty reduction goals requires an *explicit government commitment* – including corresponding resources – to provide a minimum level of public services for all citizens. This level need not be the same for all governments: highly impoverished countries and failing states will have different prospects than better resourced middle-income countries. However, unless the State defines the range and scope of minimally acceptable services, as well as its own responsibilities in providing them, it will be difficult for citizens to hold their political leaders accountable.

Focusing the debate on achieving the MDGs ensures that the priority outcome of service reform is the impact on the lives of the poor rather than specific indicators of service performance. It is worth emphasising that this approach is consistent with some of the basic principles of conventional policy analysis, especially those of maximising public spending on the poor and increasing the accountability of service providers to service users. But an MDG-centered approach also sharpens the recognition of the fundamental challenges to achieving poverty reduction goals posed by commercialisation and privatisation.

Rather than embrace fiscal savings as an intrinsic good, such an approach asks what equity trade-offs are involved in applying user fees and how the policy will affect affordability. In particular, an MDG focus questions the policy relevance of 'willingness-to-pay' surveys that show that poor people are willing to use a significant amount of their own income to pay for utilities and social services (Water and Sanitation Program 1999). It is not surprising that low-income people state that they would pay commercial rates for basic services when the State does not provide them. Such services are central to their livelihood and even survival. However, paying commercial rates inevitably requires poor people to cut back on other consumption: food, clothing, and other commercialised services. The fact that people may make sacrifices to survive does not justify a policy that forces them to make those sacrifices.

BOX 1

Basic Services and MDGs

Effective delivery of core basic services is crucial to achieving the MDGs, both as specific goals in and of themselves and as inputs to other targets. Poverty is multi-faceted and requires an integrated response across sectors. The basic services addressed in this paper have a direct impact on poverty and interact to promote specific MDGs.

Electricity helps reduce poverty by increasing productivity, and improves health by reducing indoor pollution and respiratory ailments caused by biomass heating and cooking. It promotes education by enabling students to work at night and frees children from the burden of collecting biomass.

Improved access to **water and sanitation** is an MDG in its own right, the explicit target being to halve the proportion of people without sustainable access to safe drinking water and basic sanitation by 2015. The provision of water and sanitation contributes most directly to health by reducing water-related disease and associated child mortality. Better health, in turn, leads to higher productivity and reduced poverty. As with electricity, water access frees children (especially girls) from collection chores and improves the prospects for spending time studying. Water access is also an essential element of gender equality, easing the burden of collection and time spent caring for sick children. Accessible sanitation facilities also put women and girls at less risk of sexual assault.

The second MDG aims to provide complete **primary education** by 2015 for all children. Primary education contributes to poverty reduction by improving productivity and the ability to adapt to a changing labour market. Education is also associated with the use of contraception and access to prenatal care, reducing maternal and child mortality. Literacy programs in general improve hygiene, reduce the risk of HIV and promote the appropriate use of medicines.

Finally, **health care** is an element of three MDGs: reduced child mortality, improved maternal health and the reduction of HIV/AIDS, malaria and other diseases. In addition, improved access to health care contributes to poverty reduction. In particular, health care reduces the likelihood of prolonged illness or premature death, which can have a devastating and permanent impact on household income. It also contributes to the quality of education by improving school attendance (of both students and teachers) and mental concentration.

Source: United Nations, *Millennium Development Goals Indicator Database*, 2006. Available at <http://milleniumindicators.un.org/unsd/mi/mi_goals.asp>.

An MDG focus examines the relevant challenges and constraints in each sector and addresses them with an 'unblinkered' approach that carefully weighs the options of either private or public provision. It also entails a balanced analysis of the financial requirements for each approach, bearing in mind the different revenue-raising abilities of public and private actors. While the private sector might have easier access to international capital, for example, this is often at higher cost than government funds. Thus, in many cases, strengthening public sector provision could be the preferable option.

1.2 THE STATE'S ROLE IN PROVIDING SERVICES

Although the MDGs are ostensibly about poverty reduction, in a broader sense they represent an effort to define a minimally acceptable 'social contract' between government and citizens. The core of the contract is progress toward universal provision of public services that satisfy basic human needs and are prerequisites for individuals to realize their human potential. However, the MDGs are silent on how governments should fulfill that contract, or even which institutions – public or private – should be responsible for providing these basic services.

This working paper explores how privatisation, commercialisation, and government provision affect the implicit terms of a social contract for service provision, as well as the degree to which those terms are fulfilled. At one extreme, a purely market-oriented approach might define universal provision as access to services for anyone who can afford to pay full costs. In this case, commercialisation of access violates the spirit of universal provision by making access contingent on sufficient income. At the other extreme, the State might promise universal access to a wide array of services without imposing a rationing mechanism on quantity or quality.

While the first approach makes a mockery of universal service provision, the second approach is doomed by inevitably scarce resources. In the absence of criteria for rationing or focusing resources, social and political factors often allocate public services disproportionately to urban elites or specific groups with social or political connections to government. In this manner, the grand pretensions of comprehensive universal provision can end up becoming highly regressive in practice.

All people need water, but do they need a household connection, a yard tap or proximity to a community standpipe? All people need education to fulfill their productive potential – but how many years? All people need access to medical care, but the range of health care services varies from basic vaccination to sophisticated curative treatments. Declaring the right to such services might serve legitimate social and political ideals; however, unless those rights are specifically defined and linked to financial resources, there is little reason to expect that they will translate into benefits for citizens, especially those who have been traditionally excluded from public services.

It is widely accepted, at least in principle, that the State should be responsible for making the most essential services available to everyone. Some decades back in the developing world (and today in many developed countries), that responsibility had been defined as direct government provision of services. These services have been widely regarded as public goods, and paid for with central government funds. However, during the 1990s, as market reforms became popular among development institutions and governments, the State's responsibility was re-defined as the regulator of private sector providers. Public services were increasingly

seen as benefits accruing primarily to individuals and households, and therefore required private payment through user fees that were high enough to cover costs.

The transformation of the State's role has its analog in the transformation of the service user: from citizen to consumer. While citizens hold leaders accountable through elections and political mobilisation, consumers hold service providers accountable through individual spending decisions and, if service quality or price is unacceptable, by switching to another provider (when possible). Proponents of market reform often argue that political leaders are able to avoid accountability. They conclude that while citizens have weak political resources, consumers can demand better services by giving pricing signals in the market.

However, market-oriented solutions to accountability are plagued by at least three major problems. First, to the extent that spending decisions discipline service providers, those with little or no income can be excluded from public services. Often the poor cannot even become consumers due to their inability to pay for services. Second, the consumer's strongest signal, the decision to change providers, cannot be used for services that are natural monopolies, such as water and electricity utilities. Finally, private provision of public services requires effective regulation by states, which often have weak governance institutions and little experience in monitoring or enforcing complex contracts.

Ultimately, states are responsible for promoting universal access to essential public services. But doing that requires resources. Governments with deficient services cannot promise access for everyone in the short term. However, they can articulate goals for progressively achieving universal access, and dedicate the resources required for doing so. This is what the MDGs have been created to encourage.

For every developing country in the world, raising sufficient revenue from a resistant and largely impoverished citizenry is a key obstacle. After all, why should people spend more of their income on a government that has already failed to provide basic services? Even well-intentioned governments thus face a political Catch-22: more revenue is needed to improve and expand services, but improved and expanded services are needed to justify increased taxation. Thus, a downward spiral of both declining revenue and service can result.

International donors can help by financing up-front investments, especially for construction of infrastructure. However, to make universal service delivery sustainable, the State must ultimately assume responsibility for covering recurrent costs, ideally through general revenues, and for certain kinds of consumption, possibly through user fees. By first expanding access and providing tangible benefits for excluded or neglected groups, the State can better justify higher levels of taxation. Procuring those resources is essential, however. As all too many development projects have shown, one of the most discouraging scenarios is spending or borrowing huge sums of money to create services that only fall later into disrepair and disuse.

In the rest of this working paper, we attempt to cover a broad range of topics. Section 2 examines the variety of options associated with market-oriented reforms. Section 3 evaluates the drawbacks of such reforms, particularly with regard to achievement of the MDGs. Section 4 documents the lack of empirical support for privatization, as well as for commercialization. Section 5 reviews the potential sources of financing for the provision of essential public services. Section 6 examines the role of civic engagement in strengthening the public provision of services. Section 7 provides a conclusion.

2 MARKET-ORIENTED REFORMS: THE VARIETY OF OPTIONS

Over the past two decades or so, there has been a growing policy focus on the perceived problems of State inefficiencies. Recent efforts to reform public services seek to reduce the role of the State, either by scaling back public financing or through the government's direct role in service provision. However, the nature and scope of such reforms vary considerably. While there are numerous forms of market-based reforms, the most basic distinction is between commercialisation and privatisation.

Broadly speaking, *commercialisation* is the process of transforming a transaction into a commercial activity, in which goods or services acquire a monetary value. Under this approach, a service provider seeks to cover most or all of its costs directly from individual (or household) service users. The reduction or elimination of subsidies is a common form of commercialisation. At a bare minimum, commercialisation can simply require that basic operations and maintenance are covered by sufficient revenue from consumers. A more expansive approach covers replacement cost for depreciating assets. The broadest definition includes the capital outlays for expanding and upgrading network connections to all users or constructing new facilities and covering the debt servicing costs associated with borrowing funds for this purpose (Revels 2005).

A more controversial reform is *privatisation*, in which a private company takes over some or all operational responsibilities, and is compensated either through user fees or a fee-for-service paid by the government. Privatisation reforms that make profitability contingent on user fees entail commercialisation by their very nature. Government regulation of private services focuses largely on how much firms may charge to earn a 'fair' return on investment. Increasing the number of private sector operators in order to generate competition – especially when only a government provider exists – is also a form of privatisation. If governments could ensure robust competition among qualified providers of services used by the poor, reform could conceivably improve service quality and reduce price. However, as discussed below, the monopolistic nature of key basic services is one factor that makes competition difficult to achieve in practice. Moreover, effective regulation will still be necessary even when competitive conditions exist.

2.1 WHY HAVE THESE POLICIES BEEN ADOPTED?

There are several reasons why market-oriented reforms have been promoted and adopted. Although service reform policies vary significantly, they are broadly inspired by an intellectual movement in public administration called New Public Management (NPM). NPM borrows heavily from public choice economics, the main premise of which is that government services fail because of a 'principal agent' problem: political and bureaucratic leaders control information and resources that allow them to pursue their own individual aims and ambitions, rather than operating in the public interest. Adherents of NPM maintain that public services can become more accountable and efficient when run according to market principles – that is, when providers respond to market incentives.

The arguments underlying commercialisation and privatisation policies are similar but not identical. Broadly speaking, commercialisation addresses a revenue problem, while privatisation addresses either long-term investment constraints, governance weaknesses, or both. In some cases, privatisation may be adopted as an instrument to achieve commercialisation itself – that

is, to eliminate fiscal losses stemming from public subsidies. The popularity of market-based approaches stems largely from a growing dissatisfaction with the effectiveness of the State as a service provider. However, as discussed below, global institutions play a central role in pressuring borrowing governments to adopt NPM reforms in public services. But from an MDG perspective, the track record of market-based reforms has not lived up to the ambitious expectations of its promoters.

Commercialisation

Commercialisation often signals an effort to cut fiscal deficits or generate more financial resources for the service itself. It can also discourage profligate use (as for example in the water sector). Commercialisation is perceived as an *economic solution* to the problem of scarce resources. Finance ministries often promote commercialisation to slash subsidies. Fiscal pressures can be so strong that financially viable and well-performing utilities are sold off to produce large 'one time' increases in government revenue. When a government is intent on privatising a service, an increase in user fees is often a prior step that makes the enterprise more attractive to potential private owners.

In some cases, public services are provided – in principle – to all users, including the non-poor, free of charge or at highly subsidized rates. But evidence suggests that public service subsidies tend to benefit the middle class disproportionately (World Bank 2002a, Gwatkin 2003). For peri-urban residents without formal utility connections or the rural poor who live far from government-funded services, lack of service access precludes them from benefiting from subsidies. User fees are thus often promoted as a distributionally progressive reform that could generate more income and direct it to services and programs that poor people do use. However, the rationale for user fees tends to be more common for utilities than for health care and education.

Privatisation

The rationale for privatisation might include fiscal discipline, but often goes beyond the need for resources. Reformers often point to the inefficiency and poor quality of public sector services as the rationale for a change in ownership. They present private sector participation as an *institutional solution* to poor governance. In the annals of public provision, poor governance has been portrayed in many ways: bureaucratic inertia and disincentives to innovate, low technical and managerial capacity at all levels of service delivery, lack of accountability to consumers, absence of incentives for workers to perform, political constraints to laying off under-performing or unneeded workers, and rent-seeking and corruption. In short, the institutional rationale for privatisation characterizes the private sector as being more competent, innovative and accountable than the public sector.

Proponents of privatization often advertise that the most compelling argument for privatisation is poverty reduction. The initial logic of the link to poverty points to a potential increase in fiscal space for pro-poor programs. As government saves money by withdrawing subsidies from 'loss-making' public utilities, it can direct those resources (as well as lump sum revenues from sales) toward more deserving public services, especially health care, education and basic social security. However, leaving aside for the moment the empirical question of how much fiscal space is actually opened up through privatisation, there is little reason to expect that poor people who have been politically neglected for decades will suddenly become the primary beneficiaries of increased revenues.

More recently, privatisation proponents have argued that there is a direct link to poverty reduction. Particularly in the case of poor people who lack connections to basic utilities, some advocates have maintained that private sector participation can help the poor simply through expanding access (Birdsall and Nellis 2002). There is evidence that access can improve after privatisation. However, as discussed below, the source of that expansion is typically related more to traditional public resources than to investment made by private providers themselves.

Privatisation can also emerge spontaneously as a result of a weak State. In the absence of adequate public provision, citizens are forced to use private providers. For example, where people lack access to piped water or natural water sources, they often pay very high per-unit prices for bottled or tanker-delivered water supplied by private vendors. Social services are no exception. "While India has a well developed primary health system in theory, in practice, access to services is compromised by high rates of health worker absenteeism and often inadequate supplies and poor infrastructure. This leads the majority of the population to turn to largely unregulated private providers" (UNMP: 163).

The Role of the World Bank

A key reason for developing country governments to privatise is the persuasiveness and power of international donors that support the policy. Among the global institutions that promote economic development, none has more substantive impact over policies affecting public service delivery than the World Bank. Not only is the Bank the world's largest donor, but it also conducts and produces research with a volume and scope unequaled by any other institution. Through financial resources, contracting of scores of consultants, and its self-styled role as the world's 'knowledge bank', the World Bank influences much of the policy agenda for regional and bilateral development agencies, borrowing governments and the academic community.

The World Bank increasingly promoted market-oriented reforms in basic service sectors throughout the 1990s. Service privatisation became a central pillar in the Bank's approach to development with the April 2002 approval of the Private Sector Development (PSD) strategy. Providing a general framework for the Bank's other sector strategies, the PSD strategy explicitly designates services such as infrastructure, education and health care as 'frontier' sectors for private investment. In its 2004 World Development Report, the Bank maintains that government's role in infrastructure sectors should generally be limited to regulation and pro-poor subsidies, asserting that "there are few advantages to the government's providing [infrastructure] service itself . . ." (p. 16).

As another example, the Bank's 1997 health sector strategy states that "in low and middle income countries, weak institutional capacity to deal effectively with regulatory problems in the private sector often causes governments to become excessively involved in the direct production of health services" (quoted in Abbasi 1999). Accordingly, "the Bank has made numerous loans to support managed care initiatives that convert public health institutions . . . to private management and/or ownership" (Iriart et. al. 2004).

The Bank's private sector arm, the International Finance Corporation (IFC), conducts numerous promotion and guarantee programs that steer private investment toward basic public services. Its health care portfolio has grown from 15 companies and an investment of US$ 67 million in 2000 to 32 companies in 23 countries with an investment of US$ 220 million in 2005 – excluding pharmaceuticals. These activities include loans and minority equity positions in projects that include general and speciality hospitals, diagnostic services (such as laboratory and imaging), hemodialysis, ambulatory care and managed care (Ellena 2005).

In education, the IFC considers proposals from private sector sponsors that target large-scale school projects in developing countries. It currently holds over half a billion dollars in infrastructure investments, including numerous water and wastewater projects. The World Bank's Private Participation in Infrastructure database provides information on over 3,200 projects with private investment that it has financed in energy, water, telecom and transport. (See Tables 1 and 2).

TABLE 1

World Bank Investment in water and sewerage projects by region and year of investment (US$ million)

Year of investment	East Asia and Pacific	Europe and Central Asia	Latin America and the Caribbean	Middle East and North Africa	South Asia	Sub-Saharan Africa	Total Investment
1991-1995	3,414	38	5,717	0	0	0	9,168
1996-2000	12,299	2,781	11,546	0	0	133	26,758
2001-2005	3,496	1,280	3,709	711	2	12	9,209
Total	**19,207**	**4,098**	**20,971**	**711**	**2**	**146**	**45,134**
Percentage of total	**42.6%**	**9.1%**	**46.5%**	**1.6%**	**0.0%**	**0.0%**	**100%**

Source: Private Participation in Public Infrastructure, World Bank and PPIAF, available at <http://ppi.worldbank.org/ explore/ppi_exploreSector.aspx?sectorID=4>.

As shown in Table 1 for 1991-2005, the great majority of World Bank financing of private projects in water and severage, i.e., almost 90 per cent, has been in East Asia and the Pacific and Latin America and the Caribbean. About nine per cent has been in the transition economies of Europe and the CIS. But the highpoint of World Bank financing in these sectors was during 1996-2000, when it provided about US$ 26.7 billion. Its financing declined to US$ 9.2 billion during 2001-2005.

Tables 2 shows a somewhat more diversified picture for World Bank financing of private energy projects during 1990-2004. East Asia and the Pacific and Latin America and the Caribbean have accounted for about three-quarters of all financing. Europe and the CIS follow with about 11 per cent and South Asia with almost nine per cent. Similar to the pattern in water and sewerage, the highpoint of World Bank financing of energy projects, namely, reaching a total of US$ 148.5 billion, was during 1995-1999. Its financing dropped to US$ 92.7 billion during 2000-2004.

For both water and sewerage and energy, World Bank financing of private projects in sub-Saharan Africa has been nil. Its financing of water and sewerage in South Asia has also been miniscule. This illustrates the general pattern of the lack of private investment in infrastructure in poorer countries. It is difficult to motivate private investors to place projects in such countries.

In addition to creating institutional mechanisms and resources specifically dedicated to private sector development, the Bank affects basic services through explicit loan conditions that introduce or expand private sector participation in water and electricity. The most highly publicized and politicized conditions have been in the water sector, which has seen some of the most aggressive privatisation and some of most spectacular privatisation failures (ActionAid 2004, MacCuish 2003, CCODP 2005). The Bank has also established privatisation conditions for electricity generation and management of electricity utilities (Dubash 2003).

TABLE 2

World Bank Investment in energy projects by region and year of investment (US$ million)

Year of investment	East Asia and Pacific	Europe and Central Asia	Latin America and the Caribbean	Middle East and North Africa	South Asia	Sub-Saharan Africa	Total Investment
1990-1994	16,740	1,524	13,048	3,132	3,763	139	38,344
1995-1999	42,661	13,813	69,681	6,968	12,294	3,152	148,565
2000-2004	19,667	16,344	40,591	3,891	8,233	3,908	92,663
Total	**79,097**	**31,681**	**123,320**	**13,991**	**24,288**	**7,198**	**279,574**
Percentage of total	**28.3%**	**11.2%**	**44.1%**	**5.0%**	**8.7%**	**0.0**	**100%**

Source: Private Participation in Public Infrastructure, World Bank and PPIAF, available at <http://ppi.worldbank.org/ explore/ppi_exploreSector.aspx?sectorID=2>.

3 THE DRAWBACKS – AND IMPLICATIONS – FOR MDGs

Privatisation and commercialisation are intended to improve service delivery, primarily as a result of greater efficiency and immunity from political manipulation. However, there are numerous difficulties associated with these policies that range from challenges in implementation to its destructive impact on State capacity. Furthermore, these policies have been oriented around efficiency. Issues of equity and social justice have been largely neglected or treated as having secondary importance.

3.1 ATTRACTING INVESTORS

A major stumbling block in the privatisation process emerges if no investors are interested in what is being privatised. Based on market incentives alone, private sector investment does not go to the areas of greatest need. Governments in low-income countries often have to make trade-offs and compromises in order to attract international capital into basic service delivery. International firms, in particular, require certain prerequisites before investing their own capital. In addition to good infrastructure, a safe physical environment and a capable workforce, they often demand tax and contract arrangements that minimize or even eliminate commercial risk.

Bringing foreign direct investment (FDI) into infrastructure in poor countries can be particularly challenging because of the high levels of investment required, the long payback period and the potential political difficulty in charging tariffs that ensure a commercial return. The frequency with which water and sanitation concessions in both developing and industrialized countries have been postponed or cancelled in recent years is evidence of how difficult it is to design and implement successful private sector involvement in water supply and sanitation services. For example, over half of the 307 contracts signed for private sector participation in the transport and water sectors between 1989 and 2000 in five Latin American countries (Brazil, Argentina, Chile, Colombia and Mexico) were renegotiated (Guasch, et. al. 2005).

Private investment in the social sectors is also problematic, particularly for services used primarily by the poor. The most publicized example of investor apathy in the health sector is development of drugs that treat ailments that primarily afflict poor people, such as malaria or tuberculosis. While private capital finances many health care facilities, it is targeted primarily at

urban hospitals and clinics that serve customers who are able to pay commercial prices, often for highly sophisticated services. Health services for peri-urban and rural people remain almost exclusively delivered by the State and non-profit organizations.

Various measures have been adopted to make the provision of infrastructure and basic services more attractive to private sector investors. However, these can work against the interests of the poor. For example, prices can be increased in the run-up to privatisation. This may contribute to financial sustainability, but in some cases, prices have been raised to beyond cost-recovery level not only to make the operation attractive to investors, but also to make subsequent price reductions appear to be a gain from privatization. This was the case with water privatisations in Buenos Aires (Loftus and McDonald 2002) and Manila (Dumol 2002).

Second, private providers can be allowed to focus on the consumers or regions that are most likely to be able to pay. Specific districts can be 'ring-fenced', for example, in the delivery of water and sanitation services. Utility concessions almost invariably begin with the coverage of those with existing connections – typically households with formal land titles and higher incomes. Provisions to extend private service coverage to those who are more difficult to reach or with less income typically require significant commitments of public resources.

So-called 'cherry-picking' means that the State is left with the less profitable and more challenging areas or with consumers without the revenue from the more lucrative areas. In the power sector, for example: "One … possible consequence of private power participation in a small economy is that independent power generation may remove high-load factor customers from the grid system. This is likely to result in increasing the cost of serving the remaining customers and thus in more defections, with higher costs and lower system reliability to be borne by the economy in general" (Chiwaya 1999: 305).

3.2 RISK ALLOCATION

Risk is a major concern for private investors when they take over provision of public services. With regard to capital-intensive public services, private firms are so risk-averse that they require explicit guarantees of long-term profitability. An array of instruments called 'fiscal supports' is used to attract uncertain investors into risky markets. These include cash subsidies, in-kind grants, tax breaks, direct capital contributions, as well as guarantees against risks that are not even under government control (Irwin 2003).

To appease the concerns of investors, contracts are increasingly designed to minimize risk exposure for the private sector.[2] Importantly, risk does not disappear, but rather is borne by the developing country government – or directly by consumers. Furthermore, because private investors in infrastructure require long term predictability, contractual arrangements are often set for a protracted period and the private firm then has little incentive to modify activities to take account of changing circumstances. Given that private firms are nervous about risky investments in developing countries, they seek comfort in contractual guarantees that virtually ensure profitability. In an extensive review of private health care provision in developing countries, the World Health Organisation found that contractual risk was often shifted onto government, "putting no pressure on contractors to be efficient" (WHO 1998: 24).

In the energy sector, so-called Power Purchase Agreements (PPAs) can require public utilities to buy 100 percent of electricity produced from a private generator, in hard currency – regardless of fluctuations in demand or exchange rate value. PPAs ensure long-term

profitability for private generators, and can expose governments to huge fiscal risks and losses that cannot be restructured through re-negotiation. In other words, PPAs can virtually eliminate the prospect of commercial risk. For example, a case study of energy sector reform in Bangladesh concludes: "From a policy perspective, such long term contractual obligations, especially overly-generous ones, are an inadequate substitute for a proper regulatory structure" (PURC 1999).

The consequences of investor-friendly policies can have serious implications for fiscal stability, which, ironically, was one of the original justifications for privatisation itself. While privatisation is supposedly associated with the inflow of funds, risk-free contracts and guarantees require governments to underwrite private sector projects. For instance, as a result of a combination of the devaluation of the currency and economic contraction in Asia in the 1990s, governments were faced with mounting bills to power companies while domestic revenue fell.

While some privatisation proponents are more than willing to use the public purse to attract private sector participation to infrastructure, those who have studied the financial instruments in this area are far more circumspect. A senior economist at the World Bank warned that risk guarantees dampen private sector incentives to manage efficiently and can become costly, while also arguing that protection against currency fluctuation might, in fact, encourage investors to take unwarranted exchange rate risks (Thobani 1999). An analyst at the Asian Development Bank has explicitly advised borrowing governments not to provide guarantees for water projects (Blanc-Brude 2004).

3.3 REGULATION NEEDS INFORMATION

Water and energy projects require large capital investments that require many years to recover. Corporations want rules that allow them to charge prices high enough to turn a profit, as well as assurances that government will not interfere in their pricing decisions once investments have been made. In other words, they want to ensure that government regulators do not deny them opportunities to make a profit.

The regulatory system determines who shoulders basic kinds of risk in infrastructure projects due to various factors: design and development; construction; operations (cost overruns, delays); financing (changes in exchange rates and interest rates); politics (changes in government policy); demand shocks that affect consumption; and the natural environment. Regulations governing these risks can become a major constraint on private sector participation in infrastructure.

In the United States, when a utility requests a tariff increase, an experienced regulatory commission typically reviews the request at a public forum in which business, consumers, unions and communities may present their own findings and pose questions (Palast, et. al. 2003). In most developing countries, where nothing close to this process exists, regulators have two basic choices for responding to demands for price increases: grant the request, which may be totally unjustified, or deny it, thereby incurring the wrath of the private sector and damaging the 'investment climate', which the international development institutions claim that poor countries must nurture in order to attract foreign capital. Regulators always face an inherent tension between the political and social desire to keep prices low and the demand by private firms to ensure that prices are allowed to increase in line with costs.

Private providers have strong incentives to limit what regulators know about the utilities they operate. According to a World Bank researcher on infrastructure: "The fundamental problem of regulation is one of asymmetric information between the regulated company and the regulatory agency. The regulated company will have a strong incentive to abuse [its] strategic advantage by under-supplying information or distorting the information supplied" (Foster 2003). Two infrastructure specialists elaborate on this problem of calculating operating costs: "If the regulator uses firm-specific information [to set prices], the company may be tempted to change some of its accounting outcomes to affect regulatory behavior" (Burns and Estache 1999).

Some privatisation proponents regard governments that are unwilling to allow firms to charge higher prices as hopelessly unrealistic. Another World Bank infrastructure specialist complains about government resistance to private profit: "This is not to say that private companies with a monopoly to supply water services should be allowed to take any level of profit that they choose. But governments should be *realistic* about the profits that they should allow, recognizing the need of their private partners to earn a reasonable return and to be rewarded for the risks that they shoulder" (Brook Cowen 1997). The problem is that this approach avoids the central problem facing weak regulators; they *do not know* what price is realistic, fair or reasonable. And what is a realistic price in a middle-income country might be decidedly unrealistic in a poor country.

3.4 REGULATION NEEDS EFFECTIVE INSTITUTIONS

An effective and credible regulatory framework is required to protect the interests of consumers and the State, as well as investors. It is particularly important for investors in infrastructure, where services are often characterized by large sunk investment costs, and for consumers of services that are provided in a monopolistic market. There are two main aspects to regulation – the economic dimension (such as pricing and productivity) and the quality dimension. Regulation can be applied not only to privatised service providers, but also to State-owned providers. However, private sector investors can create a particular incentive framework that allows them to conceal information and manipulate costs to maximize profit.

There is an extensive literature on the relative merits of alternative types of regulation. The most common distinction is between 'cost-plus' (or 'rate of return') regulation and price caps. While most economists prefer price caps, citing greater incentives to increase efficiency, in practice, both kinds of regulation share fundamental similarities, requiring extensive monitoring of costs to function effectively (Jouravlev 2000). In addition, regulation needs to be set in the wider context of the legal framework and the legitimacy of the regime. But there are some generally accepted clear parameters that need to be in place for effective regulation of basic service providers (e.g., transparency, independence and accountability).

Unfortunately, a lot of advice from industrialized countries becomes irrelevant when applied to low-income countries with weak institutions. Many developing countries have (under pressure from donors and financial advisers) imported regulatory regimes from industrialized countries, such as the UK and USA, which rely heavily on information, technical expertise and transparent institutional norms. Such models are rarely adapted to take account of conditions in developing countries, where, for example, the advanced accounting, auditing and taxation systems required are largely absent.

According to the World Bank's 1998 publication *Privatisation in Africa*, "In not one country with a privatisation program has there been an effort to develop a regulatory framework as an integral part of that program." Similarly, economist Manuel Angel Abdala concluded in his study of Latin American privatisation: "Widespread privatisation has been encouraged all over the region. With a few exceptions, however, the transfer of ownership was hurried or performed under constraints imposed by economic and political objectives that tended to overlook the importance of regulating private monopolies" (both quotes from Bangura 2000).

When the State is unable to monitor service performance, consumers are vulnerable to over-pricing or low-quality service delivery – or both. For example, in India the private health sector has grown without any oversight or coordination and is largely unregulated. Several studies indicate that parts of the for-profit private sector are involved in unnecessary procedures, such as high rates of caesarian sections, unwarranted tests and surgeries (World Bank 2004). In the water sector, regulators are usually unable to compel firms to disclose information about performance or prices. Yet without such data, it is not possible to verify, for example, if cost-based tariff increases are justified. In Gabon, the regulator found it difficult to monitor the activities of the private operator: "In the absence of regulatory and monitoring tools to enforce quality… it is very difficult to ascertain the potential for further improvements and the overall efficiency of the company" (Tremolet and Neale 2002: 51).

A number of solutions to the problem of weak regulatory capacity have been suggested, perhaps most notably the outsourcing of regulation itself (Tremolet et. al. 2004). Alternatively, the World Bank is exploring the possibilities of forming expert panels for regulating water companies (Shugart and Balance 2005). However, such approaches raise the age-old question of who regulates the regulators. At some point a capable State must assume overall regulatory authority.

3.5 PRIVATISATION IS NOT COMPETITION

Reformers have promoted market-oriented policies in public services based largely on the assumed benefits of competition. However, competition does not spontaneously emerge from privatisation. Rather, it requires relatively low barriers to entry. Infrastructure services that require very large capital expenditures to start up are not likely to attract many competitors in poor countries. For competition to be effective, there is usually a need for government regulation to prevent collusive pricing behavior.

For the basic services assessed in this paper, market structure and market failures militate against the achievement of genuine competition, especially in weak institutional environments and in the absence of a vigilant regulator. While we make the case that expanding and improving access to each service is crucial for achieving the MDGs, the various service sectors exhibit important economic differences that affect the likelihood that competition will contribute to poverty reduction goals.

The size and 'lumpiness' of investment affect the number of potential suppliers. Utilities tend to be natural monopolies, while social services are not. Water and sanitation services, as well as electricity transmission and distribution, have monopolistic traits due to their delivery over a single network. But there can be many hospitals, doctors' offices, medical labs, schools and training centres – although not necessarily many medical insurance providers. One potentially competitive utility sector is electricity generation, since many generators can sell energy to the same grid. But in practice, utilities are rarely competitive because of the need for investors to have investments underwritten by long-term guarantees.

Privatisation proponents maintain that all basic services can be improved through increased forms of competition. In the case of utilities, they argue that competition in the bidding process itself helps reduce utility prices for consumers. In the case of health care, education, and electricity generation, privatisation advocates argue that consumers benefit from direct competition: low barriers to entry and the ability to choose among multiple suppliers. The following sections assess special economic characteristics of each service sector in order to evaluate claims about the benefits of competitiveness.

3.5.1 Water and Electricity Utilities: Competition for the Market?

Proponents of privatised utilities acknowledge that there can be no competition 'in the market' for natural monopolies. Instead, they argue that competition *for* the market – among bidders who seek to manage or operate utilities – is still a powerful force for improving financial performance and quality. The idea is that in order to win the contract, companies will submit bids committing themselves to high performance and low prices, locking in the benefits for consumers when the contract is awarded.

The preconditions for such competition are daunting. First, a sufficient number of qualified firms must participate in the bidding process. But water delivery is one of the most concentrated businesses in the world, for example. Just two firms account for well over half of global private provision. Not surprisingly, most developing countries simply do not have domestic firms with experience in building or running large complex utilities. Evidence suggests that in many cases, transnational infrastructure firms link up with domestic companies in poor countries because of their political influence, rather than their expertise in the sector (Bayliss, Hall and Corral 2001).

Another factor affecting competition is how often re-bidding occurs. According to the World Bank's Private Sector Development strategy, "The benefits of competition [for the market] are likely to be greatest if the contracts are re-bid frequently." However, this ideal is not realistic for all kinds of private provision: "Frequent re-bidding is less feasible where the private sector is required to provide the bulk of the investment capital. Re-bidding concession-type contracts requires highly detailed provisions for the transfer of, and compensation for, assets funded by the incumbent concessionaire" (World Bank 2002b).

The World Bank's analysis serves as a useful initial basis for establishing preconditions that promote competition for the market. Contracts with low fixed private investment should be subject to frequent re-bidding. The re-bidding process itself should be open and make it possible for the incumbent to actually lose the contract. Since capital-intensive private investment precludes frequent re-bidding, the opportunity to win new bids (based, for example, on reputation) emerges as the best way to ensure the benefits of competition.

Finally, there is extensive evidence that concession contracts change, regardless of the initial bidding process. Governments often lack the bargaining power and negotiating experience to deal effectively with such contracts. Because of ambiguity, contested information about asset conditions, or unrealistic baseline assumptions (e.g. about demand or efficiency gains), contracts are frequently re-negotiated, typically to the advantage of the provider. Once a firm wins a contract, it can use its control over information and analysis, as well as the improbability that government will cancel the concession, to lobby for major changes.[3]

According to World Bank research, long-term concessions have had particularly unstable contracts. Of more than 1,000 private concession contracts awarded in Latin America during the 1980s, for example, over 60 percent had to be renegotiated within three years (Guasch 2000). In the water and sanitation sector, 74 percent of all contracts in Latin America have been renegotiated over the last 20 years, the majority of which were initiated by private operators (Guasch 2004). The high level of renegotiation undermines the nature of the competitive bidding process. While renegotiation may be expected in a long term project where conditions change over the years, evidence from Latin America indicates that renegotiation takes place after an average of just 2.2 years from the start of the contract (Estache et. al. 2003).

The need to minimize risks is leading both governments and private firms to adopt short-term management contracts. The benefit to the government is that if the firm's performance proves to be unacceptable, negative impacts will be limited to a specific set of activities, rather than overall operational performance, and the contract can be terminated much more quickly and easily.

3.5.2 Competition in Health Care and Electricity Generation

While the benefits from competition are difficult to achieve in utility services, market forces might have greater potential to discipline private providers in sectors with relatively low barriers to entry. Moreover, significant levels of private sector participation in health care and education have long been the norm in most countries. In theory, competition in these sectors could result in tangible benefits (Megginson and Netter 2001). However, it is important to consider the ways in which market failures and institutional constraints can militate against achieving the MDGs in these two key service sectors.

Health Care

Privatisation advocates frequently cite health care as an area in which competition can generate both greater efficiency and superior service. However, provision of health care is unusually complex. There is a vast array of public, private, and mixed systems that range from highly successful to dysfunctional. Unlike basic infrastructure, choosing health care reform is not a matter of selecting among a small number of distinct models with clear ownership arrangements, but rather of shaping incentives for public and private providers. Private health care typically emerges as a response to weak government service, rather than a deliberate policy.

Claims about the private sector's ability to improve equity and choice in health care provision are challenged by considerable evidence about imperfect information and market failure, which can arise from "the strong power imbalance between providers and patients" (Biljmakers and Lindner 2003). An empirical review of contracted medical services calls into question the private sector's management capabilities, the existence of genuine competition and the translation of competition into efficiency gains, as well as government capacity to design and enforce appropriate contracts with private providers (Waelkens and Greindl 2001).

A World Health Organisation literature review concludes, "the limited evidence available [about contractual efficiency] suggests that the conditions necessary for competition, and even for contestability, are generally absent from most areas of most low and middle-income countries." (WHO 1998: 29). Advocating for greater competition in healthcare provision in developing countries can end up making conditions worse, especially when increased efforts are concentrated on marketing rather than adequate provision of services.

Health care is particularly subject to market failures related to lack of information. According to an IMF researcher: "Allocation can not be based solely on cost-effectiveness, which focuses on efficiency, but ignores equity . . . Markets alone cannot produce efficient outcome in the health care sector, which suffers serious [market] failures due to asymmetry of information, imperfect agency relationships, barriers to entry and moral hazard." Because patients know far less than physicians about how to 'consume' health care, doctors have tremendous power to induce consumption (Hsiao 2003). In other words, because of the supply-side particularities of health care, demand can be induced with relatively little consideration for price. As a result, private provision that is not rigorously regulated is often characterized by over-supply.

Health Insurance

In addition to direct provision of health services, health insurance has emerged as an area in which international donors and governments have encouraged competition. Yet private health insurance (PHI) reaches only a tiny fraction of people in developing countries. Only 11 developing countries in the world cover even 10 percent of total health expenditures through private insurance (see Table 3). For market enthusiasts, those numbers illustrate a tremendous potential for growth of PHI. For skeptics, they are evidence of the inherent limitations for privatised risk-pooling in low-income countries with endemic poverty.

Health insurance is unique among the services that we are examining because the sector's financial sustainability depends on risk pooling. Ideally insurers cover broadly, randomly and without discrimination, so that the contributions of relatively healthy people cover the medical costs of the minority of the population with health problems. In practice, privatised insurance has been plagued by inequity. One of the most fundamental problems is that PHI is usually available only to better off people and those who participate in the formal labour market. (Musgrove, et. al. 2002). That is, in a typical low-income country, only a minority would even be considered for private insurance.

In addition, even among those with sufficient income, incentives to reduce risk undermine the equity of PHI coverage. In a review of insurance schemes adopted in Chile and Colombia, a Harvard University health policy specialist identified several shortcomings. Private companies engage in 'cream skimming,' using personal information to exclude sick people and those likely to become sick (Bossart 2000). Research conducted by the Inter-American Development Bank on privatisation in Chile – a country with some of the strongest institutions in the developing world – reports that health insurers "try to exclude beneficiaries who develop expensive illnesses." The government responded by requiring insurers to renew all policies upon request. However, the insurers "found a way around this obligation: they raise the price of the renewal plans while offering new plans with similar benefits at the original lower prices to clients that do not represent as high a risk level" (Fischer, et. al. 2003).

Even proponents of private insurance reinforce these concerns. According to an OECD report, "PHI offers certain advantages over other forms of health financing. In general, PHI will offer personalized insurance packages and competitive premiums, *particularly to good-risk individuals*. . . " (Drechsler and Jutting 2005; emphasis added). Yet the fundamental criticism of extending PHI is precisely because it is offered disproportionately to 'good risk individuals' who can pay premiums from their own income, leaving a population of poorer and sicker people to be covered by under-funded State health care.

TABLE 3

Private Health Insurance in Latin American and African Countries (2001)

Latin America	Importance of PHI*	Africa	Importance of PHI*
Argentina	14.5	Algeria	1.3
Barbados	7.9	Botswana	6.9
Bolivia	2.6	Cape Verde	0.1
Brazil	21.0	Côte d'Ivoire	8.7
Chile	22.6	Egypt	0.3
Colombia	11.9	Kenya	7.5
Costa Rica	0.5	Madagascar	5.1
Dominican Republic	0.3	Malawi	1.0
Ecuador	4.7	Mali	11.5
El Salvador	2.6	Morocco	13.8
Guatemala	2.7	Mozambique	0.2
Honduras	3.5	Namibia	23.2
Jamaica	13.0	Niger	1.8
Mexico	2.7	Rwanda	0.1
Nicaragua	2.1	Senegal	3.5
Panama	5.8	South Africa	42.3
Paraguay	17.5	Tanzania	2.3
Peru	7.2	Tunisia	5.4
Suriname	0.3	Uganda	0.2
Trinidad and Tobago	4.0	Zimbabwe	19.0
Uruguay	37.4		
Venezuela	1.7		

* expenditure on private prepaid plans as a percentage of total expenditure on health: not including countries without PHI or where data were not available. Source: Dreschsleri and Jutting 2005.

Electricity Generation

Market failure in electricity generation has been widely documented, from California to South Asia. Several special features of electricity make it particularly vulnerable to price manipulation. Most importantly, electricity cannot be physically stored. Moreover, there must be sufficient supply available to meet demand at 'peak' hours, even though this level of supply is used only for a short time every day.

Implementation of electricity restructuring requires considerable institutional capacity. According to an MIT economist's review of the sector, steps necessary to achieve robust competition are many and complex. This review concludes that while effective implementation of these measures can yield significant efficiency gains and lower prices for all consumers, attempting such reforms entails serious risks for governments with weak regulatory institutions. "Creating a set of complete markets that operate this quickly, at so many locations, and without creating market power problems is a significant challenge." Perhaps most importantly, the high inelasticity of demand at peak operating levels can create extremely volatile spot prices that are "unusually susceptible to the creation of opportunities for suppliers to exercise market power unilaterally" (Joskow 2003).

The challenges of creating well-functioning electricity generation markets are demonstrated most powerfully in developed countries, where regulatory institutions are more experienced and have far greater financial and personnel resources than in poor ones. According to the US National Commission on Energy Policy, "Electric industry restructuring [in the US] has derailed. The massive blackout of August 14, 2003 certainly was not needed to underscore the point, but it adds urgency to the effort to find solutions. Wholesale markets continue to evolve slowly and erratically but are impeded by state and federal conflict, regulatory and legislative uncertainty, malfeasance, poor credit and outright collapses, of which Enron is only the most notorious." Similarly, the US Federal Energy Regulatory Commission reported "evidence of manipulation of both gas and electricity markets". In western electricity markets the commission identified "abuses and misconduct, such as taking unfair advantage of market rules, excessive pricing or bidding, and behavior that is not consistent with competitive markets . . ." (Gelinas 2003).

3.6 EQUITY

The UN Millennium Declaration calls for the management of global challenges in accordance with basic principles of equity and social justice. Equity is regarded as a fundamental value, essential to international relations in the 21st century. However, the focus of market-oriented reforms has been on the operating efficiency of public utilities, not on their distributional impact.

The profit-centred incentive framework of the private sector is inconsistent with expansion of access to poor users. Investments in basic services are characterized by increasing returns to scale, network externalities and other positive spillovers. These 'public good' characteristics mean that private supply of such investments will be far below the social optimum – certainly below the level required to achieve the MDGs. Even if there are adequate total savings in the economy, providing adequate supplies of such public goods implies mobilizing resources through public rather than private channels.

For example, even if roads can be financed by tolls, if that investment will deny large numbers of poor people access to transportation, it would be better to use general revenue to promote universal free access. This assumes, of course, that general revenue could be made available for this purpose. Similarly, the social returns to mass immunisation make public financing more desirable than private financing if the latter leads to limited public uptake of services (UN Millennium Project 2005). In a frank assessment of the gap between initial expectations and actual outcome in infrastructure services, a World Bank privatisation specialist notes:

> As for the poorest, most reforming governments would simply make sure that they would impose universal service obligations (USO) to avoid possible exclusions from any segments of the population. There was, however, very little discussion or commitment made with respect to the financing of these USO . . . For the poorest of the poor . . . the speed at which access rates have improved [under privatisation] has been such that many have not yet been included in the investment plans of the utilities . . . Moreover, cream-skimming in the design of reforms has often left rural and sub-urban areas out of the service obligations. (Estache 2004: 7, 15).

Pricing of services becomes essentially a political issue. However, privatisation can push up prices where weak regulation limits the State's ability to determine the costs on which requests for price increases are based. In Guinea, for instance, expansion of access after privatisation was less than anticipated because prices were so high (Menard and Clarke 2000). Because private investors will expect a return on capital to meet their commercial objectives, tariffs will be pushed up. In Bolivia, for example, prices increased dramatically with the award of a concession contract in Cochabamba (which subsequently collapsed following huge public protests). As well as covering future investment, the tariff increase incorporated the need to guarantee a 16 percent rate of return on capital to the private concession-holder.

In addition to the pricing of services, access to services is also affected by the private firm's revenue focus. Their initial emphasis is on short term measures that immediately affect cash flow with little cost. While at first sight privatisation may appear to increase the number of connections, closer examination of the rate of disconnections may mean that a large proportion of connections are inactive. Evidence from privatised water utilities in sub-Saharan Africa indicates high levels of disconnection for non-payment. In Senegal in 2002 as many as 12 percent of connections were not in service in the capital, and even more outside the capital. In Côte d'Ivoire, private sector customers have been routinely cut-off for non-payment, even though the payment system was designed to discourage non-payment by providing a free one-time 'social' connection. In 1997, it was estimated that the private water firm, SODECI, carried out 17,000 forced disconnections. In some of SODECI's areas of operation, up to 20 per cent of connections were reported to be inactive in 2002 (Tremolet et al. 2002).

3.7 FRAGMENTATION AND TWO-TIERED SERVICE

While weaknesses in State provision have turned many governments partly toward the private sector, there are considerable disadvantages in a fragmented, two-tiered service. Indeed, dual service tiers were a large part of the original motivation to nationalize water service provision in developed countries (Hall 2003).

Proponents of privatisation and competition argue that reforms should increase the accountability of both State and private providers. Yet the policies that they champion do little to promote accountability. Rather, they facilitate the exit of service users from public provision – typically those with the highest incomes. Pressure for reforming government services is possible only to the extent that vocal or influential citizens use those services. Yet when middle class and commercial users are able to opt out of State provision, they lose any interest in holding the State to account.

The 'opt out' trend is evident in initiatives to promote private insurance. The risk-averse incentives of insurers have broad implications for the level of equity in the health sector. As a consequence of cream-skimming, competitive privatised insurance encourages the development of a "two-tiered system, with the beneficiaries of private plans having significantly higher levels of services and expenditure than the public insurance system. This outcome is particularly likely if . . . employees will be able to 'opt out' of the social insurance scheme and take their contributions with them to private plans" (Bossert 2000: 10).

Numerous country reports in the 2003 *Social Watch Report* found that public education systems were eroded by the promotion of private schools. The report on Chile reported that education reform helped channel public subsidies to private schools that were free to select

among the most prepared and well-off students. As municipalities with fewer resources were forced to take on more low-income students, quality suffered, inducing more parents to reject free public education. The Costa Rica report described a private school boom that drew better-off students away from public schools with declining resources, and concluded that "education has changed from being a mechanism for social mobility to becoming an instrument of status and exclusion." The Malaysia report repeated an alarmingly common theme: "two systems have emerged: higher quality private education for those who can afford it and poorer quality public education for those with low incomes."

3.8 EROSION OF THE STATE

The ideals that have traditionally motivated the public sector include citizenship, equality, representation and justice. The widespread adoption of neo-liberal reforms is replacing these public service norms with market driven norms, such as efficiency, productivity and profitability, which are eroding the principles of public service. Such an approach might encourage public service managers to pay greater attention to increasing productivity rather than responding to the changing needs and expectations of citizens. Similarly, such reforms are associated with a narrowing of the composition of service recipients, as the public sector is encouraged to pay greater attention to market demand while neglecting the overall well-being of citizens (Haque 2001).

The neo-liberal aim of creating a State that is a facilitator rather than a provider of services ultimately reduces the capacity of the State to meet the needs of citizens. The activity of regulation is very different from that of direct implementation and moves the State further away from the citizens that it is supposed to serve. The creation of 'autonomous' government agencies might reduce traditional forms of political manipulation. However, regulation can never replace politics itself. As a result, the establishment of arms-length government might simply promote greater influence by the private entities that are regulated, while undermining traditional systems of public scrutiny and accountability.

The capacity of the State hinges on its credibility and on the degree of public trust in public service. This, in turn, is affected by the confidence of public employees themselves. Haque (2001) cites numerous examples that demonstrate that self-confidence and perceived job security in public sector employees have declined, with the result that increasing numbers want to leave the public sector. He also points to growing dissatisfaction of citizens with the public sector. In part, this can be attributed to persistent derogatory connotations attached to the public sector, perpetuated by business, neo-liberal political leaders, the media and international financing institutions, which help legitimize and finance market reforms.

Public sector management has suffered greatly under austerity programs sponsored by international financial institutions (IFIs). Critics of mismanagement caution against sending 'good money after bad'. Yet inadequate resources lock governments into a vicious cycle of poor governance. Countries without resources cannot afford to pay decent salaries or establish institutions that prevent political abuse of the State sector. This results in large-scale inefficiencies and wasted resources (UN Millennium Project 2005:32).

In line with other aspects of neo-liberal tight budget constraints, extensive reliance on private sector participation and commercialisation reflects a systematic effort to scale back or circumvent the State, rather than strengthen it. In developed countries, government accounts

for more than 40 per cent of GDP, while in developing countries it is less than 20 percent of GDP. No industrialized country spends less than 5 percent of GDP on government-financed health services, but most developing countries spend less than half of this proportion. Rarely do industrialized countries spend less than 4.5 per cent of GDP on publicly financed education but few developing countries spend as much (Mehrotra 2003).

In addition to eroding public resources, IFI policy pressure can undermine the legitimacy of the State to undertake any kind of program. Policies that are perceived to originate in Washington-based institutions are typically adopted without public participation, and often without even minimal legislative input. Policies that are implemented without public dialogue or parliamentary debate are unlikely to correspond well with government capabilities and experience.

4 THE LACK OF EMPIRICAL SUPPORT FOR PRIVATISATION

Overall, there is little empirical support for preferring privatisation of public services. Evidence suggests that public services perform about the same as private ones even on strict economic terms, where private providers would be expected to outshine government. A recent review of infrastructure performance conducted by a team of World Bank researchers made the following conclusion. "For utilities, ownership often does not matter as much as sometimes argued. Most cross-country studies find no statistically significant difference in efficiency scores between public and private providers" (Estache, Perelman and Trujillo 2004).

Hence, given the evidence, what explains the widespread (and widely reported) perception that privatized services are superior to public ones? There is broad scope for widely different interpretations of an individual case. Empirical assessments of the impact of reforms such as privatisation are often flawed for several reasons.

Counterfactual thinking. Proponents of market reform often use the 'counterfactual of inaction'. It is common to compare best-case private provision scenarios with the continuation of failing public service. That is, privatisation enthusiasts assume that the status quo – e.g., insufficient resources and poor management – will continue indefinitely in the absence of their reform approach. For example, according to the IFC, "private investment and management are crucial in achieving efficiency gains, in extending access, in realizing lower costs, and in avoiding the poor governance characteristic of most parastatal utilities. However, new instruments and approaches will be needed to attract this private participation, and it is unlikely to come without some public or donor-provided support. *The outcome will still be clearly superior to continued government ownership and management*" (IFC 2003, emphasis added). Similarly, while a World Bank private sector specialist recognizes problems caused by private contracting in water and electricity, he concludes: "While some governments have not been able to deal successfully with [problems of privatisation], these problems will not be solved by a reversion to public provision" (Harris 2003). For some champions of private sector provision, the alternative of reform of government services and improved accountability for the State is simply not considered an option.

Inappropriate indicators. Policy research often focuses on parameters and indicators that are priorities for private providers or finance ministries, such as profitability, rather than indicators that matter more to poor people, such as access and affordability. For example, according to an evaluation of the privatised water and electricity provider SEEG in Gabon: "the company's financial profitability and their ability to maximize profits … remains the main test of whether the concession arrangement is successful" (Tremolet and Neale 2002: 50). Senegal's water concession, a showcase of innovative contract design, resulted in improved quality and more customers. Yet the greatest price hikes have affected water standposts, namely, the water source used overwhelmingly by the poorest users (Brocklehurst and Janssens 2004). An overall assessment of service provision outcomes depends on the priorities attached to the impact on different groups. Privatisation affects, in a variety of ways, numerous stakeholders, such as consumers (connected and unconnected), producers, employees and State power holders. The MDG perspective focuses on the delivery to the poor. This means that policy outcomes need to focus on affordability, access and the treatment of non-payers.

Rigging the game. Policies have become associated with particular benefits that are an artificial by-product, rather than an intrinsic feature, of the specific reform. A key example is the release of donor funds contingent on the implementation of privatisation. Indeed, the imposition of a loan condition that requires private sector participation is tantamount to creating a counterfactual of financial inaction. Conditionality often gives a cash-strapped government the choice between privatisation with resources and the continuation of a fiscally starved public service. Moreover, privatisation might accompany numerous actions that improve performance, but that have nothing to do with ownership itself: raising tariffs for the non-poor or expanding access to formerly excluded areas. As a result of selective financing, privatisation promoters have been able to point to numerous successes that result almost entirely from greater resources, such as more connections installed, better water pressure and greater reliability of service.

Selection bias. Evaluation of the relative performance of privatised utilities is subject to selection bias. Privatised enterprises typically share certain positive characteristics that will affect subsequent performance. For example, in the water sector, the performance of privatised services is typically related to the performance of the public service that the private sector replaced. In Africa, for example, two water sector privatisations that are considered successful (for Gabon and Senegal) were already performing well before privatisation, making them suitable candidates for sale (Bayliss 2003). A World Bank political analysis of water sector reform concluded that privatisation "will be more likely in cities where the water price is closer to cost recovery at the start of reforms" (Shirley 2000: 7). Indeed, from a business perspective, a service should demonstrate satisfactory financial performance even to be considered a suitable candidate for private sector participation.

Time frame. The performance of a privatised service can vary significantly depending on when it is assessed. In Guinea, water services improved for the wealthy for a short time but the lease was not renewed after ten years (partly due to water price hikes). Despite limitations with the

policy, it was regarded as a success in some ways (Menard and Clarke 2000). But since the expiry of the contract in 2000, water supplies have been worse than ever. By the end of 2003 it was reported that "thousands of men and women wander the city every day with containers in their hands looking for drinkable water."[4] Thus, taking a long–term perspective, privatisation has failed to deliver. For several years the Maynilad water concession in Manila was touted as a showcase of successful water privatisation. The company's multiple requests for rate hikes and its ultimate financial collapse revealed the concession's mismanagement (Esguerra 2003). In the U.S., neo-liberal reformers presented California's electricity sector deregulation as evidence of the superiority of unfettered markets. The subsequent collusion of generation companies and the manipulation of spot market prices eventually cost consumers billions of dollars and led to a national debate over regulatory requirements for the energy sector.

Narrow parameters: It is not difficult to find particular cases in which privatised services have expanded access for the poor. However, such success stories typically involve significant injections of government or donor financing. Empirical studies on the impact of privatisation also often neglect to consider the wider policy context. Research by Galiani et al. (2005) finds that child mortality fell by 5-7 per cent, mainly in poor households in areas of Argentina that had privatised their water supply – an outcome linked directly to greater water access. However, the research fails to indicate how the expansion was financed. The biggest water privatisation in the country was the privatisation of Aguas Argentinas, and large increases in numbers of connections were achieved after privatisation. Yet much of the initial investment was funded by loans from the World Bank, IDB and the European Investment Bank, which together provided about US$ 500 million – enough to cover major financial needs for the first three years (Biche 1998). Arguably, the public sector could have carried out the investment if such funds had been made available. Furthermore, tensions grew between the firm and government following the freezing of prices in 2001. The major investor in the project, Suez, eventually pulled out of the contract, in September 2005.[5]

5 FINANCING OF PUBLIC SERVICES

Large amounts of investment are required to achieve the MDGs, both to cover capital and recurrent expenditure. According to the UN Millennium Project, only with a huge push in basic investments in key sectors (roads, electricity, ports, water and sanitation, nutrition, disease control, education) can the poverty trap in low-income economies be overcome (UN Millennium Project 2005). While there is consensus on the need for greater investment, less clear is how much is required, in what time frame, and how these investments should be financed.

While many estimates have been made, nobody really knows precisely how much money is required to achieve the MDGs (Estache 2004). Data on infrastructure finance are hazy due to lack of official statistics; estimates vary depending on the assumptions made. According to the Global Monitoring Report, it is estimated that in sub-Saharan Africa, infrastructure investment of around US$ 17-22bn is needed from 2005 to 2015, including both capital and maintenance expenditure. Estimates place current public infrastructure investment at about US$ 6bn a year and private commitments are around US$ 4bn. Thus the infrastructure financing gap is around US$ 7-12bn a year or 4.5 per cent of GDP (GMP 2005).

In the water sector, it is estimated that to achieve the MDG target, annual investment in developing countries must increase from US $9bn to US$ 12bn and for sanitation from US$ 4bn to US$ 18bn. About one third of this investment is needed in East Asia and the Pacific, close to one-third in South Asia and nearly one fifth in sub-Saharan Africa (GMP 2005).

Certain features of infrastructure investments in developing countries affect financing issues. Most costs are incurred in foreign exchange (US$) and revenues are paid in domestic currency, leading to the risk of currency fluctuation. The level of finance required for infrastructure investment can vastly exceed the capacity of domestic capital markets. This means that international borrowing is required. In addition, the payback period for infrastructure investments can last for 20 to 30 years, creating long-term uncertainty and increasing the risk premium that investors demand.

Historically, the vast majority of infrastructure finance has come from the public sector. Despite the push for privatisation since the early 1990s, approximately 70 per cent of infrastructure investment in developing countries is financed by governments or public utilities from their own resources or from non-concessional borrowing. The private sector accounts for around 20-25 per cent and official development assistance for 5-10 per cent (Estache 2004, DFID 2002). In the poorer countries of Asia and Africa, there has been far less private sector investment than in countries with higher incomes. ODA greatly exceeds private capital flows (DFID 2002). In sum, even if there were progress in increasing private sector participation, the bulk of financing would need to come from the public sector and ODA (GMP 2005).

5.1 PRIVATE SECTOR FINANCE

In the early 1990s, there was substantial optimism regarding private sector investment in infrastructure and initial results were promising. However, private investment peaked in 1997 and has tailed off since then. In Latin America, "Very roughly, infrastructure investment levels today average 40-50 percent of what they were 10-15 years ago . . ." (Estache 2004:8). Furthermore, the private sector has failed to invest in areas of greatest need. Between 1995 and 2004, more than 70 per cent of private sector infrastructure investment went to telecommunications and less than three per cent to water and sewerage (see Table 4).

The annual average private investment in the water sector between 1990 and 2000 was US$ 2.7bn, and this fell to US$ 1.9bn over the period 2001-2004. This can be compared with the estimated annual investment required in the water sector to achieve the MDGs, which is around US$ 6.7bn. The decline in investment flows reflects changes in the size and type of water projects having private sector participation. The average project size fell from US$ 156m in 1999 to US$ 59m in 2004, but the average annual number of projects changed only from 28 in 1995-2000 to 27 in 2001-2004 (Izaguirre and Hunt 2005).

Clearly the private sector is not going to be the main source of finance for the MDGs. As a former British Environment Minister put it: "Private sector finance will certainly be important but it will generally not be used for basic services . . . private sector investment is at present insignificant at providing basic water and sanitation services to the very people who most need it" (Meacher 2001). Even those who champion private investment have come to the same conclusion. The World Panel on Financing Water Infrastructure, chaired by former IMF Director Michel Camdessus, conceded that "compared with other types of infrastructure, the water sector has been the least attractive to private investors" (Winpenny 2003).

TABLE 4

Investment in infrastructure projects with private participation in developing countries by sector and region 1995-2004 (US$ billions)

	Total	Percentage
By Sector		
Electricity	207	18.88
Natural Gas	34	0.94
Water and Sewerage	33	2.96
Telecommunications	375	70.20
Transport	99	7.02
Total	**748**	**100.00**
By Region		
East Asia and Pacific	161	13.57
Europe and Central Asia	133	19.50
Latin America and Caribbean	326	27.15
MENA	39	17.00
South Asia	51	14.98
Sub-Saharan Africa	38	7.64
Total	**748**	**100.00**

Adapted from Izaguirre (2005).

Moreover, much of the investment that is privately financed comes from taxpayers or end users. As discussed earlier, infrastructure projects are underwritten by a government commitment to pay for a fixed output at a price agreed on in foreign exchange. Where construction is carried out by the private sector, the government still has to pay – although payment might be deferred or fall under an alternative budget heading. In Delhi, the liabilities of the electricity distribution utility were transferred to the State before privatisation, so that the private firm started with a clean slate (Agarwal, et. al. 2003).

Such financing arrangements are essential for risk-averse investors, but for the government, they are inflexible and expensive. In addition, the private sector generally pays a higher cost for capital than the public sector, so costs could be higher with private sector involvement. For privatisation to be beneficial, it needs to result in efficiency gains that more than offset higher private sector borrowing costs and on this "the theory is ambiguous and the empirical evidence is mixed" (IMF 2004:14).

5.2 USER FEES

A key reason often highlighted for the poor financial performance of State service providers is that prices charged to end users have been too low. There is a widespread belief that key public services have been 'under-priced'.[6] The lamentable state of public health care is a major reason why donors and governments routinely call for increased user fees. Pricing of services is ultimately a political decision. Services can be completely subsidized or all costs can be recovered from users. But where there is competition for fiscal resources, governments are increasingly choosing to target subsidies to those who are most needy and to recoup costs through tariffs on more affluent users.

Decisions about cost recovery should address two fundamental questions: which people should be eligible for below-cost or free service, and how much, if any, of a service should be subsidized with funds from general taxes? (See Box 2.) Although user fees can act as a rationing tool to limit the use of scarce resources, the drawback of this approach is that it is likely to prevent the access of the poor to vital services.

Support for increasing reliance on user fees (in the water sector) stems from 'willingness-to-pay' surveys that reveal that poor users often pay far higher rates for services than more wealthy consumers. Where policy-makers had in the past sought to provide cheap or free services to poor households, willingness-to-pay evidence justified the imposition of fees on low income users.

There has been increased focus on the targeting of subsidies, especially for basic utilities. While subsidised tariffs benefit those already connected, those who have connections are typically not the poorest. The subsidy needs to reach those outside the system. Evidence suggests that in electricity and water, equity is promoted best by subsidizing connection charges rather than usage tariffs (Estache 2005).

Historically governments have cross-subsidized services by charging different rates for different users and by transferring revenues of profitable public services to those needing subsidies. For example, profits from telecoms and electricity have often been used to cover losses in water and sanitation. However, donors actively discourage the practice of cross subsidies between public services, preferring unbundling and strict financial ring-fencing. Moreover, privatisation itself undermines cross-subsidies. It is not easy to sell enterprises that are making losses. Those that are saleable are usually profitable – or at least close to recovering full costs. Potentially profitable enterprises that do not recover costs are typically restructured with increased user fees in order to attract private investors. After the revenue source of profitable operations is removed, the State is left with loss-making enterprises. This can have negative effects on the government's fiscal position. Moreover, it leaves remaining public services vulnerable to budgetary neglect.

In some cases, subsidies are provided to the private sector. In Delhi, for example, the government provided subsidies to the privatised electricity distribution companies in the form of discounted power purchased from the State-owned transmission company in order to avoid the need for substantial tariff hikes. These subsidies are paid for through general taxation. One of the advantages cited in the Delhi privatisation is that by providing the subsidy through the power purchased, it is less obvious. "It avoids the need for the government to give money directly to the private [firm] which would be politically embarrassing in most countries" (Agarwal 2003:31).

Much of the debate over user fees is driven by World Bank loan conditions and research. The Bank has been careful not to prescribe user fees as a universal solution for financing services, and recognizes the role of subsidies in protecting the poor. However, it has also argued that user fees enable consumers to hold providers accountable. That is, if service quality is unacceptable, even the poor can take their business elsewhere.

The application of the 'consumer power' argument is limited, however, since it holds only for competitive sectors. Consumers cannot benefit from choice when dealing with a monopoly. That leaves health care, and in some cases electricity generation. (Primary education might also be considered competitive, but there is a virtual consensus against user fees in this sector.) Moreover, while the Bank has written sympathetically about the need to exempt poor people

from user fees, its concerns about accountability can easily trump principles of equity. While the 2004 World Development Report argues that poor people should not have to pay out-of-pocket for primary health services, a DFID researcher complains that

> the critical point of the framework comes at the question of whether you can distinguish the poor from the non-poor. If the answer is yes . . . then you can exempt them. If the answer is no, then you need to decide whether the service can be adequately delivered without user fees. Given the current shortages in health and education in sub-Saharan Africa, the general answer to this is that services cannot be adequately delivered without user fees. Basically, it means business as usual . . . (Hutton 2004).

The Bank's halfway position involves an unavoidable judgment call that can be influenced by considerations that have little to do with poverty reduction, such as budget balancing. When is public sector accountability beyond hope? By claiming that user fees are justified when policy-makers pursue self-interested political goals or fail to hold public providers accountable (and are therefore unresponsive to their own citizens), the Bank creates a policy loophole for full cost recovery for virtually any poorly performing service, no matter how poor its users might be.

The argument for user fees carries an implicit assumption: enough consumers have sufficient income to contribute revenues to the service. In the developing world, many large cities have a middle class and working class that can pay for some or all of the costs of basic services. However, in extremely poor cities, as well as low income peri-urban, provincial and rural areas, economic realities make user fees highly questionable. For example, the expansion of infrastructure services in developing countries cannot be met by user fees. In industrialized countries with universal service, the costs are spread over a large number of users. However, in low income countries, connection costs are high. Private water firms have said that users in Africa, for example, cannot afford to pay the amounts required to increase access (Talbot 2002).

For poor countries, the collection of all possible types of user fees, charges and individual contribution combined would not provide sufficient resources to expand services as dramatically as would be required to meet MDG target 10 ("reduce by half the proportion of people without sustainable access to safe drinking water") (UNMP 2005d). A research report conducted by a major relief agency concluded that user fees "have been an ineffective form of health financing. In terms of revenue they bring in, this is relatively low, averaging from 5-10 percent of recurrent budgets for health care" (Save the Children 2005).

While user fees contribute little to service costs in low-income environments, they can cause serious negative consequences for poor people, and directly undermine achievement of the MDGs. Numerous academic studies and policy analyses conclude that user fees for health care rarely meet efficiency and equity goals, and are directly associated with reduced use of service, especially for the poor and vulnerable. For example, there is evidence that user fees discourage poor patients from completing treatment and cause delays in seeking treatment (Pearson 2004; Hutton 2004; Save the Children 2005). In the water sector, user fees have put services beyond the reach of poor consumers. Such fees were directly linked, for example, to a deadly cholera outbreak in KwaZulu Natal, South Africa (Cottle and Deedat 2003).

BOX 2

Findings from the World Health Organization Commission on Macroeconomics and Health

More than a decade has passed since the introduction of user fees and yet most countries have not achieved the theorized benefits from this adjunct to their health financing strategies. It is therefore imperative that international and national policy makers adopt alternative sources and mechanisms to finance the health care of poor populations. In the short term, increased development assistance for health from donor countries, together with increased budget allocations for health interventions by the governments of developing countries, appears to be the only viable option. In the long term, strategies based on health insurance will be needed. From the policy analysis perspective, the past and current failure of user fee schemes to meet the expectations of its proponents suggests that the theoretical analysis predicting benefits requires re-examination . . .

User fees refer to the payment of out-of-pocket charges at the time of use of health care. In this sense, they go beyond concretizing the idea that it is desirable for consumers, regardless of their income, to make contributions to the financing of public health care in addition to those they make through taxes. It prescribes the timing of the contribution relative to the time of needing and receiving health care. This specification of timing evokes market mechanisms that profoundly influence the distribution of health care among potential consumers . . .

Given the potential welfare losses to low-income consumers resulting from user fees and the associated reductions in consumption of other goods, the goal of policy debates at this period might have been to establish whether it is indeed efficient to distribute any type of health care employing mechanisms that relied on user fees. However, for almost two decades, the debate was centred on implementation problems that were presumed to prevent the realization of illusive theoretical benefits. Critical analysis to ascertain that theory does in fact predict net benefits to individuals or society from user fees for health care has ceased to be central to the user fee debate . . .

Proponents of user fees argue that in situations of free public provision of health care, where financing is also largely public, it is likely that.… there is 'excessive' use of public facilities arising out of moral hazard. Therefore user fees, which usually represent a small fraction of the true cost of production, are justified in order to prevent this excess use (inappropriately high consumption). In reality, however, poor consumers in developing countries currently most likely face significantly higher prices (access costs) than those that will lead to optimal consumption of health care to enhance the global utility function . . .

Source: Arhin-Tenkorang (2000: 5-8).

Conversely, there is evidence of significant poverty reduction where user fees have been lifted. The removal of user fees in the education sector has led to great increases in school enrolment rates (Deininger and Mpuga 2003). In Uganda, the elimination of health care fees improved access and reduced probability of illness in a way that benefited the poor in particular. Reduced incidence of sickness also led to broader economic benefits, as people became more productive. Importantly, however, improved outcomes were due, in part, to complementary measures following the elimination of user fees, including greater health care funding and efforts to increase the supply of health care.

In the water and electricity sectors, a common approach to applying subsidies is volumetric pricing, in which the first 'bloc' is heavily subsidized (or free), with subsequent blocs becoming increasingly expensive. However, this approach makes metering mandatory, which may not be practical in very poor areas. In addition, while volumetric pricing can be progressive in principle, in practice, governments have political incentives to make the first bloc overly generous, providing subsidies for the non-poor.

The volumetric pricing approach can also have the perverse effect of penalizing large poor households or those who use shared connections, while benefiting small middle class households that consume relatively little. Because it provides subsidies per household, and not per capita, it can undermine poverty reduction efforts. However, determining subsidies through more complex household characteristics, rather than consumption levels, requires extensive survey data whose costs might be prohibitive.

5.3 OFFICIAL DEVELOPMENT ASSISTANCE

Aid flows to developing countries have increased since 2001 following a decade of almost continuous decline. Between 2001 and 2003, ODA increased by 12 per cent. But much more is needed, particularly in sub-Saharan Africa. Estimates suggest that at least a doubling of ODA is needed within the next five years to build sufficient momentum towards the MDGs (GMP 2005).

While infrastructure commitments from multilateral development banks fell from about US$ 18.0bn in 1996 to US$ 13.5bn in 1999, by 2002 they had recovered to about US$ 16.0bn (Estache 2004). But in 2002, the World Bank's lending for water and sanitation projects, for instance, was only 25 percent of its annual average during 1993-97. According to the Bank's former U.S. Executive Director, Carole Brookins, the Bank's infrastructure investment lending declined by 50 percent during the 1990s, and even more steeply in the middle-income and European transition countries.[7]

Where financing needs exceed the potential for domestic resource mobilisation by governments, consumers and external sources are required to meet the gap. In sub-Saharan Africa, some countries face a gap as large as 20-30 per cent of GDP. External finance will need to be grant-based because of the magnitude of the investments involved, the extreme poverty of the countries and the fact that the investments are unlikely to yield a return in the near future. Donors maintain that users need to be able to bear operating costs, but this is highly unlikely in many poor countries. For example, in Ethiopia, where almost half of the population lives below the poverty line, consumers are unlikely to finance the operation of rural water supplies or urban sanitation (UN Millennium Project 2005d:117).

As the limitations to private participation are increasingly apparent, donors are expected to return to public funding of infrastructure: "As it has become clear that improving infrastructure services is difficult whether provision is public or private, the Bank Group has become more open to supporting public as well as private projects" (World Bank 2005: i). Water and sewerage is cited by the Bank as the sector most likely to remain in public hands. The Bank has resorted to considering lending to the public sector as a pragmatic response to the practical difficulties in securing private sector participation (World Bank 2005).

5.4 GOVERNMENT EXPENDITURE

Given the failings of the private sector and the vagaries of international aid, there is now recognition that the bulk of new investment in infrastructure will have to come from government. This calls for the reversal of the decline in public investment that persisted for much of the past decade (Global Monitoring Report 2005). Nevertheless, some donors still have misgivings about State providers and still see the State's role as one of facilitating the private sector. For example, DFID still promotes policies that improve conditions for the private sector: "with constrained public finance, donors should encourage governments to look at options for deploying funds to encourage private investment wherever feasible" (DFID 2002:21).

In Latin America, fiscal adjustment led to a sharp contraction of public infrastructure investment, from an average of 3.5 per cent of GDP in the early 1980s to 1.5 per cent at the end of the 1990s. Although infrastructure investment accounted for only a small part of overall public expenditure, contraction of infrastructure investment amounted, on average, to about 40 per cent of the observed fiscal adjustment. The steady drop in financing, in turn, eroded the quality and reach of public services, particularly in the context of a growing population. Moreover, the countries that attracted more private investment in Latin America were those that had maintained higher levels of public investment, suggesting that private and public investment are complements rather than substitutes (Serven 2005).

The contraction of public investment can adversely affect future income as basic services create assets that are important drivers of economic growth, which will itself generate revenue and fiscal space over the long term. Attempts to cut back on infrastructure spending have been self-defeating: "compression of public investment in infrastructure can be, and has been, associated under a wide range of circumstances with lower economic growth and less efficient poverty alleviation, which in turn has [fueled] fiscal insolvency which was the main concern that expenditure cuts were supposed to address" (Estache 2004b:9).

While acknowledging the importance of public investment, the IMF has continued to emphasise the need for strict fiscal discipline and recommends traditional measures to create more room for spending: namely, increasing taxes, changing budgetary priorities and cutting wasteful spending. Moreover, the IMF insists that its stability packages merely set limits on spending and deficit levels, but do not dictate which cuts governments should make. It concludes that for political and patronage reasons, most governments have preferred to keep paying salaries, while neglecting long-term investment in infrastructure (Hemming and Ter-Minassian 2004: 31).

Governments can raise funds for infrastructure finance by borrowing. This can be improved by strengthening domestic financial markets. One advantage of borrowing in domestic currency is that it can reduce exchange rate losses. Governments can also raise funds by issuing municipal bonds. In 2004, the Johannesburg City Council carried out a municipal bond issue to finance long-term infrastructure projects. The bond issue also served to diversify funding sources that had been dominated by banks, reducing the cost of borrowing and extending the funding maturity profile to better match the city government's long term assets. The credit rating for the bond issue was raised by a partial guarantee that allowed for an extension of the bond maturity. However, bond issuance requires a strong legal and institutional framework. This approach will not be easily repeated in the rest of South Africa, let alone in the rest of sub-Saharan Africa.

Government borrowing is not encouraged by donors, who instead prefer to provide investment finance to the private sector. Numerous funding instruments have been established to promote private investment in infrastructure in developing countries, such as the Public Private Infrastructure Advisory Facility (PPIAF), the Public-Private Partnership for the Urban Environment (PPPUE), the Private Infrastructure Development Group (PIDG) and the Emerging Africa Infrastructure Fund (EAIF). The objective of these funds is to encourage recalcitrant private firms to invest in developing country infrastructure. However, the evidence above suggests that this amounts to flogging a dead horse. Infrastructure development might be better served by facilitating government rather than private sector borrowing for infrastructure.

There is also scope for revising the meaning of fiscal space. The focus of the fiscal discipline imposed in the 1990s was on containing liquidity and expenditure on productive assets rather than addressing solvency and net worth. Infrastructure spending typically has a negative cash flow at first and for possibly up to about six years. Thus, liquidity targets tend to be biased against investment expenditure in favour of consumption. Fiscal discipline that focuses on liquidity has immediate fiscal benefits but can impede future growth, which can provide longer-term revenue generation. The extent to which this affects infrastructure depends on the nature and effectiveness of government spending patterns and its ability to capture the returns to infrastructure spending. Estache (2004) suggests revising the public sector accounting systems to create more fiscal space to take account of the possible trade offs between the long-term returns to infrastructure expenditures and short-term financial stability.

6 CIVIC ENGAGEMENT

The development community now acknowledges the benefits of civil society participation in economic planning and policy-making. However, participation in the delivery and regulation of public services has not received corresponding attention in the developing world. Achieving meaningful civic involvement in public service provision faces huge challenges: social exclusion, lack of institutionalized public processes, insufficient information and capacity within civil society, political domination by elites, and opposition by rent-seeking groups (Peña and Solanes 2003: 17).

Recent research on public health care services suggests that effective participation requires a strong State, capable regulatory institutions and a well-informed public (Goloobi-Mutebi 2005). In other words, the creation of participatory institutions, by itself, cannot create an inclusive political culture. Estache (2004) cites evidence, for example, from projects that claim to be participatory, but are driven by special interests or elites.

Marginalized groups are the constituencies with the strongest interest in putting poverty and equity issues at the centre of utility governance. A number of governance reforms can contribute to overcoming the obstacles to strengthening the voice of these groups. These include:

Transparency. Participation means little if citizens lack access to relevant information. For utilities, this includes data about quality, coverage, and the costs of operations and new investment. Under full transparency, service provision contracts would be publicly disclosed for scrutiny and comment *before* being approved. Consumer advocacy organisations, academics and public interest lawyers can play a major role in identifying ambiguities, loopholes or unbalanced risk allocation, and help correct (or cancel) flawed contracts before they become legally binding. In this regard, when the provider wishes to keep information secret, it should shoulder the burden of proof in making the case for non-disclosure. Transparency of regulatory decisions themselves can be guaranteed by statute (e.g. 'sunshine' laws). Periodic public reporting in accessible media (and language) is an important regulatory responsibility that promotes accountability.

Transparency is also critical for providing the public with information about service *performance*: who gets services, what kind, what level of quality, and at what cost. An innovative mechanism for disseminating such information is a 'Report Card', a survey among service users that asks respondents to rank service performance along several dimensions of

satisfaction and accessibility (Paul 1998; UN Habitat 2004: 45-50; World Bank 2001). Report Cards can be powerful instruments for promoting accountability. However, their effectiveness depends in large measure on the willingness of government to subject itself to the risk of public disclosure on performance, as well as on a robust news media that can disseminate relevant information to diverse stakeholders.

Transparency should not be evaluated in terms of quantity of documentation, but in terms of accessibility to regular citizens. Contrary to popular slogans, information is not always power. Service providers that do not wish to be scrutinized might respond to information requests by dumping mountains of data on the public, which can confuse or intimidate citizens and make action difficult. Information about utilities in its purest form – raw data – will not be comprehensible to most people. Efforts to synthesize, abridge and explain large amounts of complex data can facilitate participation.

Inclusive process. An important area for future research concerns the scope of civic participation. To date, development institutions have focused on individual consumer satisfaction, the main institutional mechanisms being codes of customer rights and complaint procedures. Accountability is conceived as the right of redress for service provision problems, such as inaccurate or incomprehensible billing, poor quality and interrupted service. More recent approaches explore the conceptual leap required for civic participation in regulation itself, i.e., involvement in decisions that affect large numbers of people, such as pricing and investment (Wood 2005).

Participatory regulation requires an institutionalized forum in which different interests and constituencies can listen to one another and be heard. Empowerment entails actual voice within the proceedings that inform regulatory decisions. In an inclusive process, hearings and formal reviews of performance and pricing issues are open to the public, and regulatory authorities take both questions and evidence from representatives of citizen groups.

Research on service provision in developed countries demonstrates that a democratic process is central to ensuring accountable service provision (Oppenheim, et. al. 2003). Case studies of civic engagement around the world suggest that citizen involvement in public service provision is both feasible and effective in achieving social policy goals (TNI 2005).

Nevertheless, the obstacles to establishing such institutions are considerable. Inclusiveness imposes major administrative costs, slows down decision-making, and can spark heated public disputes. Perhaps most importantly, it can also erode the power of those who enjoy discretionary decision-making authority. Just as it may be impractical to create an autonomous regulatory commission overnight, inclusive regulation may also evolve in stages, giving both officials and the public time to learn and adapt to more open processes.

Capacity building. Access to information and inclusion in decision-making proceedings do not, by themselves, ensure meaningful participation in utility governance. Effective participation in water and energy decision-making requires, for instance, a considerable degree of technical sophistication and policy expertise. In short, sustainable participation requires capable representation of interests. Some organised groups, such as commercial sectors, might be able to develop such capacity independently. Where civil society is highly developed, advocacy NGOs might be able to represent broader public interests.

In urban settings, a formal advocacy office represents one institutional response to represent residential (and especially low-income) consumers at regulatory reviews, and to process appeals filed by households or groups. Such offices require public resources – or voluntary mechanisms –for regular funding that ensure independence and sustain a professional staff with legal and economic expertise.

An equally ambitious approach to empowering citizens is the establishment of formal partnerships among civic groups, government and the service provider. Although such arrangements are still experimental, evidence suggests that they can make regulation of price, quality and service coverage more responsive to the needs of the poor (Tremolet and Browning 2002).

7 CONCLUSION

The preceding analysis has identified adverse poverty implications associated with privatising public services, as well as with their commercialisation. Despite years of effort, privatisation has failed to close much of the gap in the delivery of basic services in developing countries. Moreover, where privatisation is associated with greater access for poor people, much, if not all, of the financing comes from government, rather than private investors.

Achieving the MDGs requires government to make explicit commitments to fund public services, as well as to improve the accountability of public sector providers to citizens. This working paper has highlighted numerous ways in which the application of market led policies can adversely affect basic service delivery.

While some of these reforms have improved financial performance, the adoption of market-based frameworks has – to varying degrees – put the policy emphasis on meeting the needs of private sector players and diverted attention from broadening access and meeting the needs of the poor. The limitations of market-oriented reforms should not become a pretext, however, to ignore weaknesses in State delivery systems. Rather, to the extent that governments pursue reform measures, they should prioritise the improvement and affordability of services for low-income households.

However, describing flawed policies falls short of finding solutions. More difficult than identifying problems with market-based reforms is proposing viable alternatives that make universal and affordable service provision possible. Public services fail poor people for three basic reasons: lack of resources, poor governance, and social exclusion. Achieving the MDGs requires overcoming each of these obstacles.

Resources

The practical options for increasing financial resources for basic services are well-known. However, choosing the most effective and equitable option is likely to require a major political commitment on the part of governments.

For large, 'lumpy' investments such as for utilities, governments need to procure considerable sums of capital. However, user fees cannot be used to pay huge up-front costs. Accordingly, middle-income countries should work to improve their capacity to raise capital in both foreign and local financial markets. This is an objective to which development banks can also contribute.

For extremely poor countries in which the vast majority of people cannot pay user fees, higher levels of foreign aid are likely to be the main medium-term solution. It is revealing that one of the most vociferous critics of ODA and the 'industry' of international development assistance, World Bank veteran William Easterly, proposes focusing aid resources on provision of basic services. "Such tasks include getting 12-cent doses of malaria medicines to malaria victims; distributing 10-cent doses of oral rehydration therapy to reduce the 1.8 million infant deaths from dehydration due to diarrheal diseases last year; getting poor people clean water and bed nets to prevent diarrheal diseases and malaria; getting textbooks to schoolchildren" (Easterly 2006).

Today the World Bank, the regional development banks and dozens of regional and bilateral aid agencies are involved in virtually every aspect of economic development. Basic service provision is part of their agenda. But from an MDG perspective, there is a case to be made that it should be the central agenda. These institutions routinely counsel borrowing countries to better prioritise domestic budgetary allocations. But they might most benefit these countries by taking their own advice: focusing grants and concessional loans on those projects whose main goal is to increase access of poor people to basic services.

Governance

This working paper documents the notable limitations of privatisation in addressing the central challenge for improving governance of basic services: accountability to service users. In particular, where regulatory capacity is weak, governments face overwhelming obstacles in monitoring and enforcing contracts with sophisticated private sector providers. Moreover, some of the ways in which privatisation has helped improve governance – investing in technology, improving efficiency, instituting performance incentives for managers and workers – have nothing to do with ownership per se. With political commitment and adequate financing, public providers can dramatically improve efficiency while remaining subject to political oversight.

A central argument of privatisation proponents is that consumers are in a better position to demand quality services when they pay out-of-pocket. However, this is certainly not the case for natural monopolies, such as utilities, since switching providers is not feasible. More fundamentally, from an MDG perspective, the argument implies that poor people lacking the income to pay user fees are bound to be deprived of the benefits of accountable service provision.

In contrast, this working paper argues that impoverished people will be able to demand accountability as organised citizens, rather than as atomised consumers. Simply voting for leaders – itself a highly individualized action – is unlikely to ensure accountability in specific areas of governmental responsibility, including basic services. However, developing countries are rapidly accumulating experience in more focused and sophisticated institutional approaches to improving service delivery. Current challenges include creating and sustaining non-partisan organisations whose mission is to aggregate and professionally represent the interests of citizens in promoting access to affordable services.

Social Exclusion

Political economy research is largely dedicated to explaining why certain interest groups benefit from public policies and resources while others are systematically excluded. It is no

secret that political leaders tend to neglect the needs of citizens who are poor, unorganised, and geographically remote from urban centres. Under such circumstance, increasing financial resources would do little to benefit the poor; it would simply reinforce existing patterns of privilege.

One way to address the problem of exclusion is to provoke a debate that goes beyond generalities about service provision. It is widely accepted that poor countries need more money for utilities, health care and education. But a significant proportion of the public budget goes toward priorities that have little to do with achieving the MDGs: upgrading existing water and electricity services, building large urban hospitals or sending middle class students to college.

The point is not that such resource allocation decisions are always wrong or unfair. These are entirely legitimate activities that can supply significant public goods and promote development. Rather, the point is that spending public resources on services that tend to be used by wealthier citizens represents an opportunity cost for the priority struggle to end poverty: these resources could be used for objectives that are focused mostly on poor people.

At the same time, for economic or geographic reasons, it is often impractical to extend a modern, urban water system to peri-urban or rural areas. Other solutions, such as community standpipes or pit latrines, might increase access to a basic service at much lower per capita cost. Governments should not abandon a commitment to increase access to higher education. But they may want to re-think how many college degrees they finance with the general budget, and at what income level students should be supported. They should also determine how much of a trade-off higher education spending represents with regard to slowing progress in achieving universal primary education.

Recent policy experiences reveal a propensity among government officials and international development professionals to find facile economic solutions for inherently social and political problems. For example, commercialisation of public services has been promoted as a means to achieve financial self-sufficiency. However, in most countries there has never been even an implicit government position – much less a public consensus – about the degree to which basic services should 'pay for themselves'. Few people argue against full public funding for police, environmental protection agencies or primary education, because there is an underlying consensus that these services promote poverty reduction or provide public goods that cannot be achieved by markets alone. The research presented in this working paper suggests that similar benefits are obtained from public funding of other basic services, such as utilities and health care.

Proponents of user fees make a valid argument that public funding is not pro-poor when services are captured primarily by the urban middle class. They often point out that even when government laws mandate universal access to basic services, such as primary education, in practice, privileged social groups get the lion's share of the benefits. However, these pervasive problems do not militate against the need for public funding. Rather, they merely demonstrate how public spending decisions can be exclusionary. But this outcome is not inevitable.

The other narrowly economic solution explored in this paper is privatisation, which has been promoted as a way of both minimising the influence of self-interested politicians and maximising the benefits of competition. However, in addition to the serious governance

problems that it creates, over a decade of experience has shown that private provision is not likely to address the needs of the poor. Rather, it re-locates social exclusion from politics to markets. To the extent that private services do serve the poor, public resources are almost invariably behind the improvement.

Because there are strong inducements to exclude poor and voiceless citizens under any kind of service provision arrangement, whether public or private, there is no substitute for political commitment to dedicate public resources toward these groups. Perhaps more importantly than their economic weaknesses, commercialisation and privatisation reduce the political pressure on government leaders to take seriously the need to equitably allocate budgetary resources. When user fees contribute to self-financing or a long-term concession simply transfers responsibility from the State to a private company, politicians are no longer held accountable.

The key to achieving the MDGs is a public discourse over the legitimate role of government in providing essential services and how it should prioritise competing claims from citizens for such services. But that discourse can be meaningful only when government makes an explicit commitment to public funding of services instead of opting to unload such responsibility onto the private sector. This working paper has argued that the public sector should clearly define the essential public services that it is obligated to provide and, in line with its mobilisation of both domestic and external resources, progressively provide universal access to those services.

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NOTES

1. For a detailed update on progress toward each of the MDGs broken down by geographic region, see DFID (2005).

2. A common example is a 'pass-through' on costs, under which a pre-set formula adjusts tariffs automatically so that specified cost changes, e.g., oil prices, key inputs, and exchange rate fluctuations, are immediately reflected as increases in the tariff, typically without regulatory review. The purported goal of automatic tariff adjustment is to provide a secure revenue stream. However, the mechanism undermines incentives to minimise costs or avoid exposure to events beyond the control of government or firm.

3. For case studies detailing contractual changes that increased the concession's price, see Esguerra (2003) and Brocklehurst and Janssens (2004).

4. Agence France Presse, 17/12/2003 'Guinea capital lacks water, light and citizens want to know why".

5. 'Water row hits Argentine capital' www.bbc.co.uk 23/9/2005.

6. Particularly water and sewerage, health and electricity services – although notably less so in education. Among the sectors addressed in this paper, primary education stands out as a public service largely insulated from pressures to impose user fees. Indeed, the World Bank has publicly declared that primary education should be financed through general revenues. The key rationale for this exception is that education – and the literacy and numeracy skills that it makes possible – is a key to escaping poverty. Many also recognise education as a public good, benefiting not only individuals but also communities and nations, and unlikely to be supplied in sufficient quantities by markets alone.

7. *Transition Newsletter* (World Bank), Volume 14/15, April 2004.

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