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Assessing the Risks in the Private Provision of Essential Services

Tim Kessler and Nancy Alexander

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PREFACE

The *G-24 Discussion Paper Series* is a collection of research papers prepared under the UNCTAD Project of Technical Support to the Intergovernmental Group of Twenty-Four on International Monetary Affairs (G-24). The G-24 was established in 1971 with a view to increasing the analytical capacity and the negotiating strength of the developing countries in discussions and negotiations in the international financial institutions. The G-24 is the only formal developing-country grouping within the IMF and the World Bank. Its meetings are open to all developing countries.

The G-24 Project, which is administered by UNCTAD's Division on Globalization and Development Strategies, aims at enhancing the understanding of policy makers in developing countries of the complex issues in the international monetary and financial system, and at raising awareness outside developing countries of the need to introduce a development dimension into the discussion of international financial and institutional reform.

The research papers are discussed among experts and policy makers at the meetings of the G-24 Technical Group, and provide inputs to the meetings of the G-24 Ministers and Deputies in their preparations for negotiations and discussions in the framework of the IMF's International Monetary and Financial Committee (formerly Interim Committee) and the Joint IMF/IBRD Development Committee, as well as in other forums.

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ASSESSING THE RISKS IN THE PRIVATE PROVISION OF ESSENTIAL SERVICES

Tim Kessler and Nancy Alexander

Citizens' Network on Essential Services

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Abstract

Essential services, such as water and electricity, are public goods, in that their benefits extend well beyond the consumption of the individual. They are also critical for poverty reduction, and must be universally affordable and accessible in order to achieve the Millennium Development Goals. For these reasons, the standards that apply to investments in other sectors are insufficient for essential services.

Accordingly, the paper argues that private provision of utilities requires a higher burden of proof than policies reforming existing public services. It suggests that policy-makers considering options for reforming essential services should look beyond the efficiency. While these are clearly important, reform decisions should also be informed by social and 'off-budget' fiscal impacts, as well as an analysis of the feasibility of implementing reform in the existing institutional environment. Evidence about the risks of private provision shows that in many cases, the benefits of better performance are outweighed by costs in these other areas.

The paper identifies four common rationales for private provision and provides evidence that challenges their validity in many cases.

Private provision helps balance budgets. *When public subsidies are needed make services available to poor people, private provision does not reduce the subsidy, and may complicate its allocation. In addition, governments often lure firms to poor or risky areas, governments through incentives such as tax breaks, grants, and guarantees, which entail serious fiscal obligations and undermine budget discipline.*

The private sector invests in public services. *In reality, private investment in utilities has been falling in developing countries, leaving government with the same financial burdens. Moreover, private investment is often contingent on contractual terms that guarantee profits, or shift financial risk onto taxpayers or consumers.*

Private providers improve service performance. *The record here is mixed, as actual experiences range from improvement to disaster. Similarly, public sector corruption is matched by corporate scandals in public services. An important reason that private provision often fails to deliver is that governments with limited experience and resources cannot design and enforce contracts.*

Private provision makes reform irreversible. *This is often true, but can be undesirable. Policy-makers lack the information and analysis to anticipate the social and economic impacts of policies that cannot be reversed, such as commitments made under the WTO's General Agreement for Trade in Services, which could permanently restrict government's ability to regulate or subsidize public services.*

Table of contents

Page

Preface		*iii*
Abstract		*vii*
I.	Introduction	1
	The privatization paradox	2
II.	Trends in resource flows	3
III.	Mechanisms for promoting private provision of services	5
IV.	Rationales for private provision of essential services	7
	Rationale no. 1 – balancing budgets	7
	Rationale no. 2 – attracting investment capital	10
	Rationale no. 3 – improved efficiency and performance	13
	Rationale no. 4 – making reform irreversible	19
V.	Conclusion	20
Annex A	Questions about Foreign Direct Investment	22
Annex B	External pressures for local government austerity	22
Annex C	Multilateral guarantees	23
Annex D	Hubco: Pakistan’s power dispute	24
Annex E	An overview of the General Agreement on Trade in Services	25
Notes		26

ASSESSING THE RISKS IN THE PRIVATE PROVISION OF ESSENTIAL SERVICES

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I. Introduction

Recently, considerable scholarship has been devoted to researching how best to deliver essential services. Private provision[1] is explored in considerable depth in both the UNDP's 2003 *Human Development Report* (HDR), entitled "Millennium Development Goals: A Compact among Nations to End Poverty" and the World Bank's 2004 *World Development Report* (WDR), entitled "Making Services Work for Poor People". Based on a reading of the preliminary WDR draft, it appears that the World Bank is considerably more sanguine about market-based approaches to essential services, especially infrastructure services such as water and electricity, than is the UNDP – or this paper.

The two documents present substantially different positions on the question: *What is government for?* The HDR urges a larger role for government in the direct provision of services, and is circumspect about private provision. "The supposed benefits of privatizing social services are elusive, with inconclusive evidence on efficiency and quality standards in the private relative to the public sector. Meanwhile, examples of market failures in private provisioning abound" (p. 113). The WDR, in contrast, promotes a government role in facilitating private provision, and provides a number of examples of effective private service delivery to support its case.

Notwithstanding their differences, both organizations are careful to avoid categorical claims. The UNDP readily concedes that private provision can work under the right circumstances, while the World Bank both acknowledges and finances improvements in public sector delivery. However, policy-makers need to undertake specific analyses to make good judgments about which kind of provision will be both feasible and effective. The purpose of this paper is to make explicit the costs, risks and tradeoffs of private provision.

Because essential services contribute directly to livelihood, health and dignity, we argue that the decision to deliver those services through private providers should be subjected to a *threshold requirement*: the improvement of social equity and poverty reduction. Specifically, policy-makers should determine if private providers are likely to deliver essential services to low-income people who cannot afford to pay commercial prices, and if so, under what conditions.

The paper also explores the following dimensions of private service provision:

- *Service delivery performance*. To what extent will private provision improve existing levels of quality, reliability and access?
- *Fiscal impact.* When attracting private investment requires financial incentives, guarantees

or subsidies, how costly are these liabilities relative to options for reforming existing government-provided services?

- *Balance of payments impact.* What is likely to be the impact on the balance of payments of the outflow of profits and dividends to investors? This is particularly important in the case of transnational corporate acquisitions and investment.

It is important to emphasize that while operational and economic considerations are significant, achieving improvements in these areas alone should not be taken as sufficient justification for adopting or expanding private provision. Indeed, in many cases the success of the private provision model is predicated on a social bargain that excludes the poor: higher prices in exchange for better operational and financial performance. Accordingly, a normative premise of this paper is that *the standards the pertain to investments in other sectors are insufficient for essential services.* There is evidence that private provision can bring improvements in service quality for the urban middle class, profitability for companies, and fiscal discipline for governments. While these achievements, when attainable, are entirely legitimate, they have little to offer the poor.

This paper demonstrates that improvements in any given area can be more elusive than private provision advocates admit. Although private provision often achieves real improvement in some aspect of service delivery, there is often a tradeoff among the other dimensions. We argue that where private providers demand high or guaranteed returns on investment for delivering quality, equitable services, governments need to balance those costs against alternative reforms. Moreover, where private providers avoid poor people and concentrate on lucrative parts of the population, governments that are left with the responsibility for serving society's most vulnerable people need to frankly rethink private provision in both humanitarian and fiscal terms.

The privatization paradox

Proponents of private provision confront important questions about the role of the states and citizens. The recommendation to privatize public services often makes contradictory assumptions about the capacity of governments. One assumption is that poorly performing public services, characterized by corruption, low capacity or political capture, cannot be reformed sufficiently to deliver quality services. However, another assumption is that, given the requirement of effective public regulation in preventing market failures, the (same dysfunctional) state will take the leading role in monitoring and discipline private providers.

This "privatization paradox" underlies the critical precautionary principle that informs the title of this paper: *private provision of essential services bears a heavier burden of evidence than public provision.* Given the unique social contributions of essential services and the economic challenges of providing them privately, evidence of public sector failure is not, by itself, sufficient justification to adopt private provision. Private provision advocates should therefore make an empirical case that the conditions for controlling market failure and promoting social welfare are substantially in place before adopting private provision policies. The precautionary principle is informed by three important features of essential services.

(i) *Public goods.* Essential services are *public goods*. The benefits of water, sanitation, electricity, and health care extend well beyond the particular individuals who consume them. Common public goods include improved public health (e.g., absence of epidemics) and greater economic productivity. As the 2003 *Human Development Report* states, governments have traditionally provided public goods because "their market value alone would not capture their intrinsic value and social benefits".

There is broad consensus that citizens should collectively pay for "pure" public goods like national and personal security (military and police) and environmental protection. One never hears complaints that such services "run losses" – even though they are financed entirely by tax revenue – because their social benefit is so obvious. Infrastructure and social services differ from pure public goods because they can be rationed and are excludable. However, virtually all wealthy countries whose governments provide essential services justify the decision largely because of the economic challenges to providing collective goods privately.

As the massive August 2003 United States blackout demonstrated, private providers have little incentive to make low-yield investment. In the United States, for every dollar of electricity purchased, generation is worth 70 cents, distribution brings in 20 cents and transmission is worth only 10 cents. After the 1992 deregulation and unbundling of a vertically integrated sector (which separated the three main functions), investment in transmission facilities stalled, leaving the national energy grid vulnerable to overload.

(ii) *Market failure and perverse incentives.* A distinctive market logic presents serious challenges for efficient private provision of essential services. Many have argued that increased private provision in competitive sectors empowers consumers by giving them choice – primarily the option to exit. However, as will be discussed below, health care is subject to market failure related to asymmetric information: doctors can induce over-consumption of certain drugs and procedures. Unlike social services, infrastructure is not a competitive sector. In most settings, there can only be one energy grid or centralized water system, making the issue of choice irrelevant. Monopoly power enables firms to extract excessive rents from consumers lacking alternative suppliers.

For both social services and "natural monopolies" claims of superior efficiency and performance can only be realized when vigilant *public* regulators – not individual households – hold firms accountable. However, most developing countries have weak public institutions, which can take decades to establish. Moreover, where essential services have historically been delivered by the state, sudden privatization may take place in the complete absence of regulatory experience and capacity to monitor and control private sector behaviour.

(iii) *Poverty reduction.* The provision of essential services is a basic requirement for *poverty reduction.* Essential services are widely acknowledged as the principal means through which the Millennium Development Goals can be achieved. However, without effective public intervention, poor people can be excluded from, or denied access to essential services. This is especially the case when private providers lack incentives to serve unprofitable populations.

Where private provision requires commercial tariff rates and precludes progressive cross-subsidy arrangements, there are two basic options for dealing with poor people. One is to let market prices ration the poor's consumption of essential services (or other consumption that is crowded out by higher prices). Policy-makers need to assess the impact of this option on livelihood and provision of public goods. The other is to subsidize consumption of privately-provided services with public resources. Policy makers should weigh the real and potential financial costs of using the general budget (or foreign aid) to provide low-cost services through providers that require profit and may also seek to shift operational risks onto the state.

II. Trends in resource flows

Since 1998, the developing world has become a net capital exporter to the developed world. At the same time, growth rates are declining in many countries. In 2000, the world community committed itself to a set of eight Millennium Development Goals (MDGs) that would, among other things, halve by 2015 the proportion of people whose income is less than one dollar per day. In the poorest countries, the shortage of capital is compounded by a drop in official development assistance from bilateral donors. Hence, while donors and creditors espouse the importance of meeting the MDGs, they are not providing the capital needed to raised investment levels to achieve these targets. For example:

- In 2000, donor aid for education totalled $4.1 billion, with just $1.5 billion for primary education. In the 1990s, bilateral aid for education fell from $5 billion to $3.5 billion, dropping to just 7 per cent of ODA – an all-time low.[2]
- In 2000, the median per capita spending on public health was $1,061 in high human development countries; $194 in medium human development countries and $38 in low human development countries.
- In the 1990s, an average of $3 billion per year in the Official Development Assistance (ODA) was allocated to water and sanitation projects. The share of water and sanitation in total ODA

remained relatively stable throughout the decade, at 6 per cent of bilateral and 4–5 per cent of multilateral aid. (Non-concessional World Bank lending adds over $1 billion per year.)

- The total share of IDA devoted to basic social services (basic health, primary education and water and sanitation) has rarely surpassed 10 per cent. The multilateral share (United Nations agencies, the World Bank and regional development banks) accounts for a third of ODA.

Even more troubling than stagnating aid levels is the recent decline in *private* investment. Indeed, the fact that foreign direct investment levels were so much larger than official development assistance was portrayed as evidence that multilateral development banks were becoming irrelevant. Between 1988 and 1999, service sector foreign direct investment (FDI) increased at an annual rate of 28 per cent and accounted for 37 per cent of total FDI stocks in developing countries in 1999. The share of infrastructure in total FDI flows nearly doubled during 1990–1998. Hence, it is significant that net FDI inflows to developing countries fell sharply in 2002 to an estimated $143 billion compared to $171 billion in 2001. FDI has dropped to Latin America, since the region has sold most of its assets, many to foreign buyers.[3]

While FDI is often touted as the critical resource for the entire developing world, FDI flows to developing countries remain highly concentrated. Today about three quarters of FDI to developing countries goes to just 10 countries, and most of this amount goes to China, Brazil and Mexico. All low-income countries combined received only $11 billion in FDI in 2002. Economist David Woodward divided developing countries by per capita equity inflows. He found that the 71 countries receiving less than $1 per capita received a combined total of just 0.1 per cent of total equity flows, despite having 22.3 per cent of the population of the developing world.[4]

Moreover, not all FDI has the same developmental potential. Increasing foreign investors are spending on Mergers and Acquisition (M&A), rather than new "greenfield" investment in new assets and production capacity. Private provision of essential services by foreign investors, especially infrastructure, usually takes the form of sale – or long term lease – of existing assets. According to a study by UNCTAD, the share of Mergers and Acquisition in total FDI among developing countries – not including China, the largest recipient of greenfield investment – grew from 22 per cent in 1988 to 72 per cent in 1997. According to Cambridge University economist Ajit Singh: "When FDI takes the form of green field investment, it represents a net addition to the host country's capital stock. However, FDI entry via an acquisition may not represent any addition at all to the capital stock, output or employment."[5]

Recent research not only questions the developmental potential for a large part of FDI, but also suggests that its most common forms can actually undermine the balance of payments. Especially when returns on investment are very high, as they tend to for poorer countries (reflecting the private sector's risk premium) repatriated profits can have serious implications for management of foreign exchange (see annex A).

If the overall FDI picture is somewhat bleaker, when it comes to investment in basic services for developing countries, the situation is still worse. Many multinational firms have been scaling back their investment plans. In January 2003, as part of its efforts to restructure massive debt, Suez announced that it would pull back from new water business in developing countries, and curtail investment in existing operations.[6] The investment prospects for rural water service are particularly discouraging. As British Environment Minister Michael Meacher put it:

> Private sector finance will certainly be important but it will generally not be used for basic services. Thus the World Bank's database on Private Participation in infrastructure, whilst it shows that private investment in water and sanitation in developing countries to date totals $25 billion, also reveals that none is in South Asia, and almost none is in Africa. Yet these are the two regions in the world without adequate water and sanitation services. This indicates that private sector investment is at present insignificant at providing basic water and sanitation services to the very people who most need it.[7]

According to International Rivers Network, "Water multinationals have little or no interest in rural drinking water systems. Corporations are rarely able to profit from poor and dispersed rural populations who mainly depend on local water sources such as wells, springs and streams."[8] Even

small businesses appear hesitant to invest in the areas that need it the most. As a WaterAid study of rural water reform in Uganda explains, "communities that are disadvantaged by the terrain in their locality – where the more expensive technical options are required – are unlikely to benefit from [private sector] projects ... Contracts to the private sector avoid expensive deep drilling operations."[9]

The World Panel on Financing Water Infrastructure, chaired by former IMF Director Michel Camdessus, promotes private capital investment, concedes that, "Compared with other types of infrastructure, the water sector has been the least attractive to private investors, and the sums involved have been the smallest."[10] In a meeting on water policy in Uganda, staff from the French multi-national Vivendi stated that the imperative of making a reasonable profit limits investment to larger cities with sufficient per capital income. Not surprisingly, they also indicated that the decision to invest in even these urban areas would depend on the certainty of revenue streams from either government or users.[11]

Similarly, in World Bank presentation to, the CEO of another French water multinational Saur, articulated what he characterized as unreasonable demands on the private sector in developing countries, such as universal provision requirements. Noting a "marked increase in risk for the private operators, particularly in developing countries", he lamented the "emphasis on unrealistic service levels [which leads to] limited interest in the market". He concluded that investment requirements cannot be met by the private sector and that "Service users can't pay for the level of investments required, not for social projects ... The scale of the need far outreaches the financial and risk taking capacities of the private sector."[12]

III. Mechanisms for promoting private provision of services

There has been a marked trend since the mid-1990s among multilateral development organizations to promote private provision for utilities experiencing financial difficulties. It is increasingly common for the World Bank and regional development banks to finance a series of reforms that lead up to transferring control of public assets to private firms. Typically these include decentralization, corporatization, full cost recovery through commercial pricing, and segregating profit-making and loss-making markets ("unbundling"), so that profitable parts can be more easily privatized. In some cases, the Bank also finances "strategic communication campaigns" to persuade citizens in Borrowing countries of the soundness of privatization.[13] These campaigns typically contrasts best examples of private provision with the worst examples of public provision.

The IMF, whose loans are widely recognized as a "seal of approval" for developing countries, also imposes important conditions for financial assistance. It can require governments to take measures that severely limit the ability of local governments to deliver public services, even when decentralization reforms devolve service delivery responsibilities to lower levels of government. For instance, following its institutional priority to ensure macroeconomic stability, the IMF may pressure central governments to: reduce or eliminate budget subsidies (and domestic credit) to services, especially utilities that operate in the red; limit fiscal transfers to subnational governments; allow the creditors of local governments to "intercept" transfers to local governments in order to collect debt-related obligations; refrain from "bailing out" indebted local governments.

There is also evidence of pressure from multilateral development banks. Conditions for commercialization and private provision can be found in policy "triggers" for lending in World Bank country assistance strategies, as well as "tranche release" criteria for structural adjustment loans. Considerable independent research confirms such conclusions. In the electricity sector, a World Resources Institute study of six countries found that reforms were driven by the immediate need for capital, usually as the result of the withdrawal of international donor support for the power sector. In Argentina, the IDB and World Bank withheld assistance to the provinces unless they agreed to conform to federal pricing requirements. In Orissa, India, donors instructed consultants to "create a process that was irreversible".[14] In a study of ten cities by the Director of Water and Sanitation at the Asian Development Bank, only one (Macau) was found to have privatized of its own volition, having done so a century ago.[15]

Decentralization has become an increasingly common "first step" toward the private provision of services. When adequate revenues are not available

for local government, decentralization can lead to privatization by default. When local governments face increasing social demands without receiving corresponding increases in resources or capacity, they have strong incentives to unload these political liabilities onto the private sector. As the UNDP explains, "As urban populations increase, fiscally strapped local authorities cannot expand services to cover them. As a result water services decline in quantity and quality in middle-class neighbourhoods – and fail to reach new poor neighbourhoods."[16] Unfortunately, local governments are even less prepared to negotiate and regulate private contracts than national governments, which themselves have shown serious limitations in governing private providers.

While the logic behind decentralization is to put services closer to the people and improve accountability, in practice local governments are often given responsibility for delivering services without sufficient capacity or resources. "Financial decentralization often renders local governments vulnerable to macro-economic shocks and remedial measures to control public expenditures and national budget deficits ... [Amid] sharply reduced [national] spending ... the quality and reach of public services is bound to suffer in the absence of complementary measures to raise local resources."[17]

While local governments may not make a deliberate, premeditated decision to contract out public services, when faced with serious resource gaps they often have to choose between reducing access and quality, or transferring responsibility for service delivery to a private provider. In this decentralized context, the fiscal rationale for pursuing privatization may simply be one of desperation. The IMF and World Bank have played a major role in creating fiscal constraints that undermine local delivery of services (see annex B).

Even more important than old-fashioned conditions on loans is the emerging practice of *selectivity*. Through a number of new initiatives, the MDBs are beginning to use the "carrot" more readily than the "stick", a shift with potentially profound implications for aid allocation. The principle of selectivity may eventually obviate the need for conditions in country assistance strategies or adjustment loans. As countries and localities are rewarded for "good policies", the Bank increasingly focuses its resources on governments that agree to implement liberalization and privatization policies. For example, the World Bank is concentrating the bulk of its lending in India to just three states that have shown willingness to adopt policies that it supports.

The World Bank has created a number of recent initiatives to advance the agenda of service privatization. Four examples illustrate how diverse lending and non-lending instruments converge on a common policy approach.

- *Private Sector Development.* The World Bank's 1995 *Annual Report* referred to the institution's shift toward direct support of private sector investment (as opposed to direct lending to governments) as "a dramatic departure from what had been Bank policy for half a century". The Private Sector Development (PSD) Strategy, which was approved by the World Bank's Board in February 2002, puts real power behind this shift.[18] Under the PSD strategy, the World Bank's private sector affiliate, the International Finance Corporation (IFC), is to team up with the International Development Association (IDA), the World Bank's concessional loan arm, to privatize services in low-income countries, including "frontier" areas, such as social programs and basic infrastructure. The Strategy's purpose is to transform much of the World Bank Group's traditional operations into support for the role of the private sector.

- *Output-based aid*. The World Bank is scaling up the financing of infrastructure and social service projects through output-based aid (OBA) design.[19] OBA projects delegate service delivery to private "third parties" under contracts that tie provision of financial support to the outputs or services actually delivered. (Challenges to implementing so-called "performance-based" contracts are discussed in the following section). A Global Partnership for OBA was launched in 2003 by the World Bank Group, with support from DFID. It is now experimenting with and scaling up OBA schemes, some of which would provide subsidies to corporations when they deliver services or meet certain performance benchmarks. Examples of pro-poor OBA payments include one-time payment for expanding coverage (e.g., through new connections), gradually reduced financial support for phased tariff increases, ongoing subsidies for minimum consumptions in poor households.

- *Community-driven development.* One approach to private service provision that the World Bank has embraced with particular enthusiasm is community-driven development (CDD), which currently absorbs about half of IDA credits and grants. According to the Bank's website, CDD gives control of decisions and resources to community groups, not local governments. "These groups often work in partnership with demand-responsive support organizations and service providers including elected local governments, the private sector, NGOs, and central government agencies…" A common type CDD is the Social Fund, through which the Bank has channelled $3.7 billion in 57 countries, with donor and government co-financing bringing the total to about $9 billion. Social Fund resources are distributed directly to communities, rather than local governments, and often contain thousands of sub-projects, which are bid out to private and non-profit contractors. In light of concerns over weak local level governance, some have expressed concerns about how effectively CDD approaches prepare local governments to facilitate transparent privatization, or manage financial resources.[20]

- *LICUS.* The World Bank addressed the special needs of failed states through its Low-Income Countries Under Stress (LICUS) program. LICUS turns the idea of improving governance on its head. Rather than building the institutions of governance, an external institution – the independent service authority (ISA) – simply replaces the state's essential functions altogether. ISAs are largely autonomous from government, with high standards of accountability directly to donors. They are wholesale institutions, contracting out services with multiple providers, including firms and NGOs, for retail services that they monitor and compare to ensure cost-effectiveness.

In addition to pressure to implement policies that may not be appropriate or feasible, borrowing countries may have other economic and operational reasons for reducing reliance on external donors. Critics of foreign aid projects have long argued that development projects create financial traps related to *recurrent costs*, such as salaries, maintenance, fuel and routine supply requirements. For this reason, some governments prefer to borrow only for "one-time" capital expenditures, such as construction, and fund essential service provision only through user fees and budget outlays. Just as important as financial sustainability is *operational* sustainability, and area in which MDBs have not had a good record. In 1993, only 27 per cent of World Bank-financed water projects had likely sustainability (defined as long-term provision of continued benefits after project completion), while today the figure stands at around 40 per cent.[21]

IV. Rationales for private provision of essential services

This section will evaluate four common rationales given for privatizing essential services: budgetary discipline, attracting private investment, improved efficiency and performance, and irreversibility. It is not argued that these rationales are categorically invalid. Rather, this section highlights risks that may make each rationale less compelling, or irrelevant, and provides illustrative examples of those risks.

Rationale no. 1 – balancing budgets

The first rationale for privatization is that it provides important benefits for budget stability. By freeing up scarce budgetary resources, governments that sell off public assets or put them under private management can dedicate those funds to other pressing social goals. Unfortunately, this rationale has been used to privatize even well-functioning services, as the sale of attractive assets generates a one-time revenue windfall. From the perspective of private sector bidders, the most attractive services are those that already perform efficiently and satisfy a broad, lucrative customer base. Thus governments searching for large "lump sum" revenue gains may be tempted to trade away viable and effective services. There is often an inherent tension between profitability on one hand, and competition and poverty reduction on the other. Some governments have enticed companies to make high offers by allowing arrangements that have little to do with the public interest. As several World Bank researchers explain:

> In many countries, privatization transactions are spearheaded by the Ministry of Finance, which tends to view the process in narrow transactional terms, with the focus on maxi-

> mizing the fiscal revenues from the asset sale. This is unfortunate because there are some important trade-offs between the sale value of the assets, and the downstream economic and social impacts of the reform. For example, revenue considerations point toward keeping service tariffs high, minimizing rollout obligations, postponing the introduction of competition, and overlooking many of the details of regulation. However, experience shows that these are precisely the strategies that are likely to be most damaging to the poor ...[22]

Privatization of well-functioning services that are financially viable are particularly dubious. In the mid 1990s, Gabon's water utility SEEG was doing fine before being privatized, even in the opinion of officials involved in the sale. According to IFC investment officer Francois Wohrer, just before the sale SEEG was a "relatively wealthy company ... and will make a decent profit in 1996 ... The company was a little messy before 1993 but there has been a nice cleaning process over the last three years. There is no overstaffing and the company is quite well managed."[23]

Stopping losses by reducing subsidies

While the revenue-generating rationale has been used to justify selling of good services, fiscal considerations have greater legitimacy for bad ones. From a fiscal perspective, getting rid of loss-making services to improve macroeconomic discipline is more justifiable than selling off profitable or budget-neutral services. However, any fiscally-driven decision to privatize should be informed by an analysis of the *cause of losses*.

Some advocates of privatization argue that the problem underlying loss-making government services is invariably inefficiency. In many cases, there is certainly a valid case that public service organizations use up more general tax revenues than they need to. At the same time, as argued earlier in the discussion about public goods, the mere existence of a fiscal loss is not an argument for privatization of essential services. Indeed, one of the main characteristics of public goods is that they can only be provided through collective contributions from all citizens – that is, at a loss.

Privatization inevitably commercializes prices through user fees. Without some sort of subsidy mechanism, the poor will not be able to afford essential services, leading to both greater poverty and reduction of public goods provision. For this reason, the implementation or expansion of user fees almost invariably entails a subsidy dimension. The practicality of reducing poverty through targeted subsidies has therefore received considerable attention. Unfortunately, targeted subsidies often fail to reach the intended beneficiaries. The extent of subsidy leakage in fee-based systems is demonstrated in a study of Chile's private water provision, which found 80 per cent exclusion of poor people, and 80 per cent inclusion of affluent people.[24] The finding is particularly troubling given that Chile's institutional capacity is among the best in the developing world.

While subsidies often contribute little to poverty reduction, user fees themselves may contribute little to financial viability of essential services, especially in very poor areas. Health care cost recovery experiences in African countries shows that average fees yield only around 5 per cent of operating costs. The net yields are lower – or even negative – when collection costs are factored in. This finding is confirmed by a Harvard University study of health care in the United Republic of Tanzania which found that the administration of the user fee program cost more than the user fee revenues.[25] While these may be extreme examples, administration of subsidy systems in low-income countries inevitably create costly bureaucratic systems for implementation. Where private provision is linked to fiscal measures that preclude progressive cross-subsidies – especially in the context of widespread poverty – then the state may have to commit to long-term transfers from the regular budget (or foreign aid).[26]

Unfortunately, *there is no evidence that subsidy systems under private provision are any more effective than those under public provision.* According to the World Bank's Operations Evaluation Department, "getting the private sector to focus on the alleviation of poverty and to design tariffs in a way that does not discriminate against the poor has proved hard to achieve in practice ..."[27] Under traditional arrangements, government typically provide a direct subsidy to means-tested households, or to communities designated as poor. Under "output-based" contracts (see section III above) governments could pay the private provider a fee for each low-income customer served at reduced prices.[28] Such arrangements provide a profit margin for the private

provider, while requiring the government to incur substantial monitoring costs in order to ensure compliance.

Fiscal costs of attracting private capital

As discussed in section II, the more a private provider is expected to serve the interests of poor or excluded users, the less attractive will become the opportunity to invest in the sector. However, the unwillingness of private firms to invest in low-income people has much of the development community not to re-think privatization, but rather to re-think how *to finance* privatization. The influential *Financing Water for All* (commonly known as the Camdesssus report) specifically recommends greater use of multilateral guarantees for private investment, as well as direct use of development assistance to "facilitate water projects managed by private operators under public control". The global development institutions have increasingly turned to financial incentives to attract private providers into otherwise financially unattractive investments.

The use of such mechanisms to attract private financing underscores an apparent double standard. When governments run losses to subsidize publicly delivered services, conventional wisdom is that such arrangement are not financially sustainable. However, when funds from the same public sector (or lending institution) are used to finance private provision of the same service, the arrangement is characterized as an innovative approach to poverty reduction.

The salient point is that government must engage in some form of social redistribution when poor people cannot afford basic services. From a financial perspective, the main question in considering the choice of provider is: which is likely to cost the government more money? In many cases a public service may require significant subsidies, especially if it has to reach a lot of poor people. These "loss-making" enterprises are one of the main justifications for bringing in private firms. But if governments have to offer major financial incentives to succeed in attracting more private capital, policy-makers need to ask how high that price is, and if it justifies a major policy change.

It is increasingly common for the public sector to channel financial support to private providers in the effort to lure new investment in services. As one labour union researcher concludes: "Lease contracts in the water sector are designed to ensure that the risk levels that private firms face are not so high that they will put off investing. Private operators are usually invited to take over responsibility for operating and managing the network, but are not required to invest in the infrastructure."[29] This finding is corroborated even by institutions that support private provision. As the World Bank explains, incentives to attract private firms include "cash contributions during the construction period; subsidies during the operating period, e.g. in the form of non-refundable grants; and a favourable tax regime – including tax holidays, refunding of tax on construction and operating costs."[30]

Under World Bank tutelage, the Government of Pakistan began allowing private ownership of electricity generation plants in 1992. After two years without investment, a high level government commissioned produced the "Policy Framework and Package of Incentives for Private Sector Power Generation Projects in Pakistan", which included: bulk tariff of United States cents 6.5/kWh for the sale of electricity to the public utility, with indexation for fuel prices, United States and Pakistani inflation, exchange rate fluctuations, and operating and maintenance costs (see following section for more details), exemption from corporate income tax, customs duties, sales tax, and other surcharges on imported equipment, and permission for power generation companies to issue corporate bonds and shares at discounted prices.[31]

Examples abound throughout the developing world. In 2001, the Kenyan government suspended a water contract with a subsidiary of Vivendi.

> Originally this was a $5m billing and accounting project but there was an outcry when critics pointed out that Sereuca would not invest any money in infrastructure during the 10 years that the contract was to be in force but was to just install a new billing system at City Hall for which the company was to earn 14.9 per cent of the Ksh12.7 billion ($169 million) collected over the period. Furthermore, the city council's water and sewerage department was supposed to reimburse the cost of the computer equipment and hardware to the company at the end of the 10 years with no provision for depreciation.[32]

In South Africa, a power consortium led by the United Kingdom's BiWater provided only about a

quarter of capital investment in upgrading and expanding service in the Nelspruit municipality. The majority of capital for this private venture was supplied by the South African Development Bank.[33] In Honduras, AES obtained exemptions on all taxes and charges as a condition for building an 800 MW power plant in Puerto Cortes.

On top of government incentives to attract capital are multilateral guarantees to reduce corporate risk. These instruments are usually provided by the World Bank's private sector affiliates, the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA), which protect against commercial and political risks, respectively. When private firms lend to or invest in a utility project in a country, the Bank's guarantee promises the private firms compensation for certain losses if, under specified conditions, the government does not meet its obligations. The borrower may be the member country or a private company.

Multilateral guarantees can dramatically increase the "off-budget" fiscal burdens of recipient countries Subsovereign guarantees provided to state and local governments currently require backing by the central government. However, this requirement may soon be eliminated. When that happens, if private ventures backed by a subsovereign guarantee fail, the local government is likely to assume large, debt-like financial obligations without any mechanisms for restructuring or writing down the obligations. Guarantees can account for half or even more of the indebtedness in a given infrastructure service sector. (On the potential fiscal costs of guarantees, see annex C.)

In June 2000 MIGA paid out a claim for political risk insurance for the first time.[34] It made a payment of $15 million to Enron when the Indonesian government cancelled a power project. The contract – to build, operate and maintain a 500-megawatt power plant near Surabaya – was one of several independent power producer (IPP) contracts signed with the dictatorship of President Suharto. The contracts were suspended in 1997 in response to the country's economic crisis and the collapse of the rupiah, the Indonesian currency. A power utility, PLN, made clear to all the independent power producers in the country that it simply could not afford to pay the prices specified in the their long-term power purchasing agreements. Moreover, PLN and other utilities nullified the contracts on the grounds that they were created in a corrupt manner. The rationale for the cancellation and the payment of the claim were straightforward. However, after the payment was made, MIGA insisted that the Indonesian government *reimburse* the $15 million. As an incentive, MIGA refused to issue any more coverage for business in Indonesia until it was paid. After lengthy negotiations, the government agreed to repayment terms. Only then did MIGA consent to provide insurance coverage for investors in Indonesia once again.

This episode was remarkable because the project was recognized even by MIGA as economically and politically unsustainable. The guarantee agency actually agreed that proceeding with the project was not a viable policy option. "While we understand the circumstances that led to (the Enron) project suspension, international law dictated that the cancellation be compensated", said Luis Dodoro, MIGA's general counsel and World Bank Group vice-president. Thus, Indonesian taxpayers have to pay the bill for a politically corrupt and economically unviable contract signed between a dictatorship and a multinational firm. Enron, which negotiated the agreement, has received compensation, while the government of Indonesia has reimbursed MIGA.

Rationale no. 2 – attracting investment capital

The second principle rationale for private provision of essential services is that the private sector has access to far more capital resources than cash-strapped, deficit-ridden governments. Especially for sectors with high sunk costs, such as infrastructure, it is argued that fiscal constraints (or the inability to impose higher user fees) cripples developing country governments in their quest to upgrade and expand expensive services. However, as we saw in section II, expectations about private capital have run far ahead of actual investment levels, especially in the places that need it the most.

Reducing poverty

The most explicitly "social" rationale for private service provision is that it reduces poverty. It does so by increasing capital investment in infrastructure and social services used by poor people, improving quality or expanding access. Especially

where government has failed to invest in marginalized people, because of budget constraints or lack of political priorities, many argue that private capital represents the only viable opportunity for reaching these excluded citizens. Indeed, during the booming 1990s, market reformers made a mantra of the argument that the private sector was the only viable source of capital for major public investment. Particularly in the capital-intensive utility sectors, cash-strapped governments were portrayed as unable to keep up even with basic maintenance, much less to expand or upgrade costly infrastructure. However, large corporations and nimble capital markets could make large investments wherever needed.

As discussed in section II, these cheerful predictions have fallen flat. Because of the dynamic of "cherry picking", corporations have little incentive to invest in "unprofitable people". In the case of utilities, private providers like to expand household access (e.g., hook up water pipes, make connection to electrical grid) or upgrade services in urban areas, especially where middle class consumers demand more and better services. They are less likely to go into peri-urban, slum or rural areas, where topography is more difficult, per capita consumption is less, and most importantly, incomes are lower. Because the poor tend to live in outlying urban and remote rural areas, the unit costs of providing them with utility services may actually be much higher than for wealthier people living in major cities. Moreover, variation in investment location within countries is replicated on a global scale. Of total foreign investment in private infrastructure, very poor countries have received only a tiny fraction of that capital.[35]

There are numerous examples that illustrate how capital investment fails to reach the poor. In the Indian city of Tiripur, a textile and garment center, a consortium comprised of United Utilities (United Kingdom), Bechtel and a local partner are working with the state government development corporation to deliver piped water to customers who now rely on tanker trucks. Under current plans, the knitwear industry would receive 115 million liters per day (mld). "Tirupur municipality, which includes 60,000 slum dwellers, will get 26 mld, while 792 rural settlements in its neighborhood will share the remaining 36 mld."[36]

After the British firm BiWater pulled out of a privatisation project in Zimbabwe because local consumers could not pay high enough prices to generate a sufficient profit, the company's manager remarked: "Investors need to be convinced that they will get reasonable returns. The issues we consider include who the end users are and whether they are able to afford the water tariffs. From a social point of view, these kinds of projects are viable but unfortunately from a private sector point of view they are not."[37]

Cherry-picking incentives also constrain investment in social services. In the health care sector, doctors want serve patients with higher incomes, while insurance companies want to avoid sick customers, and drop those who develop conditions requiring medical attention. Expanding direct private provision of health care affects rich and poor countries alike. Under Germany's deregulation, "people with a sufficiently high income are allowed to opt out of the statutory health insurance funds. The private insurers can offer their services to young (and healthy) people far more cheaply. As a result, the statutory health insurance funds are retaining a larger proportion of higher cost members."[38]

An IDB paper on privatization in Chile reports how health insurers "try to exclude beneficiaries who develop expensive illnesses". Although government responded by requiring them to renew all policies upon request, the insurers "have 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."[39] This finding is reinforced by the Social Watch country report, which states that commercially priced health insurance for women of child-bearing years is three to four times higher than for men in the same age bracket.[40]

Shifting risk, guaranteeing profits

The World Bank strongly promotes private participation in water and sanitation, and agrees that such arrangement must ensure the profitability of firms that risk large amounts of capital. One Bank researcher called for "the need for realism" and warned that naive developing country officials may openly question the need for adequate profit levels.

> There is often a sharp difference between what private companies see as the minimal return necessary to go into business in a risky country and what governments view as an acceptable level of profit ... (Advisers to developing

> country governments considering private participation in water will all be familiar with the gasps of disbelief and indignation when they first voice assumptions about expected returns on equity.) Governments that have happily (or at least blindly) tolerated high levels of rent seeking and wasteful behavior by public water company officials can become positively puritanical about relatively modest profit taking by a private company. 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.[41]

Needless to say, what constitutes "minimal return" and "relatively modest profit" is a judgment call. Governments that are admonished to be "realistic" routinely confront private firms that have strong incentives to overstate the costs of providing services. Moreover, once private providers win a concession, they also exercise control over financial information that governments need to assess their claims.

The record of private service provision is littered with examples of contracts that guaranteed profits for firms while placing virtually all risk onto the government and consumers. The most direct way that firms avoid commercial risk is through contracts that quantify profit margins. For example, in Cochabamba, Bolivia, where civil society mobilization against water price hikes exploded into a political crisis, the public auction for the city's water system featured exactly one bid. The Bechtel-owned consortium Aguas del Tunari, negotiating terms with a government lacking any real bargaining leverage, demanded exclusive rights to all local water resources, as well as a guaranteed 15 per cent profit margin, which would be indexed to the United States inflation.[42] Enron's ill-fated gas-fired power plant in Dahbol was initially granted a 16 per cent guaranteed return by the Indian government, in top of a five year tax exemption.

Some private provision arrangements create enormous contingent liabilities for governments. A good example is the so-called "take-or-pay" contract. In the energy sector, power purchasing agreements (PPAs) commit the government to purchase a predetermined quantity of production regardless of economic conditions. Although such obligations are not technically debts, they can actually be more intractable than traditional debt because they are not subject to rescheduling and write-downs. As a survey of financially disastrous power purchasing agreements concludes: "bankruptcy is not an option under the contract terms."[43] For this reason, policymakers need to assess the potential *off-budget* implications of private provision options.

In the Indian state of Maharashtra, Enron's $3 billion Dahbol power plant was touted as the country's largest foreign investment project. However, over a decade after Enron formed the Dahbol Power Corporation (in partnership with Bechtel and General Electric), the plant is dormant while a bitter legal dispute between the government and DPC continues. In the midst of allegations of government oppression against protesters, the operators have been the charged with manipulating prices through a PPA. At the end of 2000, the Maharashtra State Electricity Board claimed that the DPC was charging over double the rate of comparable publicly-owned generators. The Board subsequently called a moratorium on payments to the DPC and in May 2001 cancelled the PPA, which led Enron to shut down operations.[44] The case remains tied up in litigation in multiple venues, while the power plant physically deteriorates as it remains mothballed. (For a case study of a failed PPA in Pakistan, see annex D.)

In Uganda, the United States energy firm AES negotiated a PPA for the Bujagali hydroelectric project that was later shown to be excessively expensive. The government has little experience with such contracts, and relied on World Bank advice in setting up the PPA provisions. An independent review by an Indian consulting firm concluded that not only were capital costs the same as other power plants with twice the generating capacity, but the PPA imposes excessive payment requirements and restricts the government's ability to sign other agreements that could reduce its fiscal exposure.[45]

Long-term power contracts have generated numerous disputes with governments which accused companies of extracting excessive financial benefits through high prices or selling unneeded energy. In addition to the cases described above, such contracts have been renegotiated or cancelled in Croatia, Indonesia, Hungary, Costa Rica and the Dominican Republic.[46]

Rationale no. 3 – improved efficiency and performance

The third rationale for privatization of essential services is both common and compelling: superior efficiency and performance of private providers. Privatization advocates often portray public sector providers as bound by bureaucratic inertia, lacking incentives to innovate, and unresponsive to helpless consumers who have nowhere else to go. Private providers are expected to improve efficiency and expand service because of inherent incentives to cut costs and to satisfy a growing number of paying customers. The state retains the role of market regulator.

There is considerable evidence supporting claims of that privatized firms have performed better than the state-run services that they replaced. Research on privatization of state-owned enterprises (SOEs) reveals overwhelming evidence of increased efficiency and profitability.[47] Moreover, efficiency improvement in basic services has often been accompanied by improved service quality and access. A review of evidence by a former World Bank economist and IDB vice president concluded that, while privatization in developing countries was associated with worse distribution of assets, it has increased access to utilities such as electricity for poor people.[48]

In addition, anecdotal evidence about improved performance makes clear that private service provision can bring significant benefits in terms of both financial sustainability and consumer welfare.[49] For example, while the failure of the Maynilad water concession in Manila has eroded the enthusiasm over this "model" of privatization, the chief regulator of the water utility involved in the dispute has vigorously defended the policy itself. He notes that tap water is actually cheaper now than before privatization, and that the other privatized concession in Manila is performing quite well financially. "Also, there are now 9.8 million people who have connections as compared with only 7.3 million people prior to privatization ... The water coverage was only 67 per cent then and now it is 92 per cent ..."[50]

A review of privatization in Chile reveals significant gains in productivity for private electricity generation (though less so for distribution, indicating that competition can have powerful effects).[51] Even more impressively, Chile's privatized water system makes safe water available to 97 per cent of its urban population and sanitation to 80 per cent. In Cartagena, Colombia, the private venture Acuacar has proved considerably more responsive to its users than the public utility and has undertaken substantial improvements in maintenance and rehabilitation – the first investments to occur after an 11-year hiatus. Water quality has also improved.

Even privatizations that have been plagued by problems have shown important improvements. In Nelspruit, South Africa, despite the threat of financial collapse because of rampant non-payment, the private firm BiWater has added thousands of new connections and meters and water reliability has significantly improved. In Trinidad and Tobago, despite the financial failure of an interim operating agreement with Severn Trent, the first two years saw an increase in average water production, greater distribution of potable water to the country's southern region, rehabilitation work on pipes and a rural water supply project benefited several hundred thousand customers.[52]

The main indicator for performance in virtually all privatization studies is *profitability or efficiency*. However, the profitability indicator is an inappropriate measure for the performance of essential services, as it reflects the satisfaction of shareholders, not consumers. The indicator of efficiency, such as labour productivity or number of outputs per cost unit, is a legitimate consideration – but it is not the only one. Essential services are expected not only to run efficiently, but also to provide high quality service and reach the poor. Equity goals in particular, however, may undermine efficiency.

Moreover, even taking efficiency on its own terms, comparative evidence does not always support private provision. A recent statistical analysis of efficiency among public and private water companies in Asia revealed that there is no significant difference.[53] In a comparison of five countries with public (United States, Japan, and the Netherlands) and private (France, United Kingdom) water provision, the number of utility staff per 1,000 connections is considerably lower in public countries than private ones. Moreover, the level of "unaccounted for" water is far higher in the private countries.[54] Moreover, as numerous examples show later in this section, among developing countries, there is a growing record of private firms who failed to turn around service utilities.

The remainder of this section examines performance among competitive and monopolistic services, as well as the critical issue of corruption.

Monopoly services and regulation

When a private provider is a natural monopoly, public regulation is needed to prevent market failure. The mechanism for ensuring compliance of monopolistic private providers is the performance contract, and the government's main job is to enforce it. While private providers in these sectors may still have incentives to improve efficiency, they have no incentive – or natural pressures – to translate higher productivity into gains for consumers. For that reason, the state emerges as the unique institution to protect the public interest. As one analyst observed, private sector participation "may actually place more rather than less demand on effective and capable public authorities. Intervention through incentives requires more skill than intervention through investment. New regulatory capacity is required to deal with these new roles."[55]

Proponents of putting natural monopolies under private provision are very enthusiastic about performance-based contracts (PCBs). A considerable body of economic literature has developed concerning the ability of PBCs to improve the bottom-line of firms that contract out for goods and services that they used to produce internally. Much of this literature concerns the so-called "principal-agent" problem. When agents (sub-contractors) have much more information and knowledge about a given task than the principals (contracting firms), they may be able to withhold or manipulate that information to their own advantage.

The only way to for the principal to overcome this problem is through adequate monitoring and evaluation of the agent's output. However, this can be quite costly, and often forces the principal to reconsider whether those extra costs – and risks – are worth subcontracting in the first place. Generally speaking, *the easier it is to observe and measure an output, the less costly it will be to enforce* a PBC. As outputs become more complex or subjective, the likelihood of undetected non-compliance or contractual disputes grows. According to John Donahue, author of a seminal study on privatization, when outputs cannot be precisely described and measured, the case for the in-house option becomes stronger. "The relative appeal of *employing* people, as opposed to *contracting* with them, increases ... the more the task at hand is uncertain at the outset and prone to revision."[56]

Notwithstanding the spotty record of PBCs in the private sector, they are now a central feature of a new development paradigm for services, commonly called "output-based aid" (OBA). Although private provision of government services has not been subject to systematic analysis in developing countries, it has been in the North. Such studies reveal a very mixed record in the developed countries, ranging from much better, to much worse, to about the same performance as the public sector. According to a review of evidence from the United States conducted by Columbia University Professor Elliott Sclar, private providers tend to do a better job than government when performing simple, low-skill activities, and a poorer job when performing more complex activities.[57] Indeed, privatized services often cost more than when public services were provided in-house.

Why is this the case? As two management researchers put it: "performance contracts are not self-administering, self-correcting, or self-improving. Performance contracts do not quickly or automatically solve the problems of vendor performance."[58] As former World Bank senior economist David Ellerman put it:

> From time to time, private sector management "discovers" the idea of paying for performance (not just for time put in), of paying for outputs (not just inputs), and of management by objectives accomplished (not just intentions). It all sounds so obvious and so sensible that one must ask "Why didn't people think of this before?" The answer is that they did. And they discovered that it doesn't work too well – aside from fairly rude forms of labor. In areas of human effort where effort, commitment, and the application of intelligence are important, the carrots and sticks of external motivation are insufficient for sustained performance. Beyond simple and specific products, the determinants of quality are rarely susceptible to external monitoring.[59]

In short, the main limitation of performance contracts is *transaction costs*. As services become more complex – and as the economic and social outcomes they are supposed to achieve become more difficult to measure with simple indicators – the pub-

lic sector inevitably gets involved. Governments often impose strict requirements on contractors regarding production processes and outputs, as well as information and reporting requirements. These details become part of excruciatingly complex and highly legalistic contracts, and end up raising the costs of producing the desired services.

Even specifying a seemingly simple output such as "number of connections" in a water contract is unlikely, by itself, to achieve equitable social outcomes. That is because there is inevitable uncertainty about what kinds of goods and services are needed, where they are need, and by whom. A World Bank research note acknowledges this constraint: "Even if a [water] contract were bid on basis of perfect information about the current status of the water company's assets and about new investments needed, the future would hold uncertainties that could not be handled by contract. And an initial contract is usually based on highly incomplete information."[60]

From a developmental perspective, Sclar's study is revealing in two ways. First, it dispels the myth of the superiority of private management of public services by demonstrating just how difficult it can be to adequately specify terms in a performance contract. Even when well-paid lawyers, accountants, bureaucrats and technicians work together to ensure that payment is based on objectively measured outputs, the record has often been disappointing. Second, Sclar's study raises serious questions about the ability of governments in poor countries to even produce, much less enforce, the complex contracts involved in transferring responsibility for public services to profit-motivated agents who have far more information than the principals.

Proponents of private provision are fond of pointing out that monopoly providers require regulation regardless of whether it is public or private. And there is no shortage of evidence about the failure of public regulators to discipline failing public providers. As the *World Development Report 2003* argues, there is sometimes a "conflict of interest" when one government entity is charged with controlling another. The poor performance of public service provision thus justifies privatization even under weak regulation. Indeed, without a private sector to monitor, how can regulators ever learn their job? While there may be problems and setbacks at the beginning, over time the necessary institutions will be created.

While there may certainly be cases in which adequate regulation of private providers is a viable option, it is important that policy-makers make their decisions based on the risks of pursuing such arrangements. At a minimum, they should ask how feasible it will be to establish a functioning, independent regulator, and the time horizon for doing so. Equally importantly, the decision to privatize should be informed by an impact analysis of private provision under weak or non-existent regulation.

In the case of long-term contracts, lack of adequate regulation at the beginning can result in a flawed contract and regulatory "capture" that is very difficult to overcome. Moreover, if it is possible to create effective regulators of private providers from scratch, it may also be possible to strengthen the capacity and autonomy of regulators that enforce public provision. From the perspective of the policy-maker, it is important to ask which of these tasks is most feasible, and to assess the relative costs of poor regulation.

Not surprisingly, regulation in developing countries is generally weak, sometimes even non-existent. According the World Bank publication *Privatization in Africa* (1998), "In not one country with a privatization 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 privatization: "Widespread privatization 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."[61]

In the developing world there is a long and growing record of private monopoly services with poor quality, financial mismanagement, and unaccountably high price hikes. One of the most spectacular failures involved Maynilad Water Services, a French-Filipino consortium that began supplying drinking water to about half of Manila in 1997, and touted by the World Bank as a showcase of successful privatization. After successfully petitioning the water regulator, MWSS, to grant a series of tariff hikes that were not formally permitted under the terms of the original contract, in December 2002 Maynilad angrily announced that it would terminate its contract. MWSS and citizens' groups argued that the company had received extraordinary

leniency for raising prices and amending the contract to postpone performance targets. However, the regulator's refusal to allow yet another rate hike in late 2002 led the debt-burdened company to abandon the concession.[62] As of this writing, litigation for damages – the government and company both demand compensation from the other – is still pending.

In 1995, a Vivendi affiliate took full control of Puerto Rico's water utility PRASA. Four years later the Office of the Comptroller issued a scathing report, describing unsatisfactory maintenance and repair, incomplete financial disclosure, neglect of consumer inquiries, customers billed without receiving water, and financial mismanagement that required stop-gap funding from the state development bank. Not far away, in the Dominican Republic, the 1999 privatization of the electricity utility – which admittedly was in very bad shape – has been a major disappointment. By 2001, blackouts were even higher than under public provision "Business owners have refused to pay higher prices for an even worse service with the result that whole communities are now disconnected."[63]

In Orissa, India, a special government commission was appointed to review the state's energy reform program, which included private provision of electricity from United States-based AES. In May 2001, after consulting with stakeholders from the provider, government, and consumers, a state-appointed review committee comprised of retired officials and academics issued a blistering report, which described: no progress in improving transmission losses after five years, deterioration of bill collection, higher debt, increased costs of generation, steep tariff increases with no corresponding improvement in finances, and the virtual absence of new capital investment.[64]

In the 2003 *Social Watch Report,* a number of country reports describe serious performance failures under private provision.[65] Before being resold in 2002, Bulgaria's private water company routinely overcharged customers, randomly cut off services, and failed to respond to consumer complaints. Between 2000 and 2001, El Salvador's privatized electricity companies presided over 44,000 power outages and saw half a million customer complaints. The list of grievances from Nicaragua included incorrect (and uncorrected) billing, service paid for but not delivered for public street lighting, as well as voltage failures resulting in damage to small appliances and business production.

Competitive services and choice – but for whom?

For services with (at least potentially) low barriers to entry, the rationale for private provision is *choice;* consumers buy services based on price and quality. Here the government's main role is to ensure adequate levels of competition that create viable choices for all citizens. Expanding private provision in competitive service sectors can certainly increase choice – but not necessarily for all consumers.

A pervasive problem associated with greater choice is the practice of "cherry picking". When private providers enter the market, they have strong incentives to serve primarily people who are able to pay commercial prices, and who enable firms to minimize overhead costs. Not only are poor people least able to pay. They are often the most costly to serve, living in less accessible areas, and more prone to getting sick.

Especially when existing public services are of low quality, expanding the choice of providers draws better off consumers into the private sector. However, those who are unable to afford commercially priced private services must remain with the state, thus creating a "two tier" system based on income. Public services that are funded through progressive cross-subsidies – or where high-use customers account for the bulk of revenues – are especially vulnerable to increased private sector participation, which reduces the public sector's revenue base.

If policy-makers do not address market failures associated with natural disincentives to serve vulnerable populations, improved efficiency may go hand in hand with increased social exclusion. Policy constraints inevitably raise issues of fairness. On one hand, neither middle class consumers (nor anyone else) should be forced to use low quality services. If greater choice can improve quality and efficiency, such benefits should not be ignored. On the other hand, poor people are already marginalized politically. After addressing the interests of the more influential constituencies by increasing private provision, governments may be tempted to "move on" and neglect complementary policies needed to serve the poor.

Multilateral lenders and borrowing governments increasingly turn to the catch-all policy of "social safety nets" to address equity under private provision policies. When done well, these can be effectively targeted subsidies and "lifeline tariffs" that ensure provision for all. At worst, they can be a budgetary gesture with no programmatic features to reach intended beneficiaries.

Privatization advocates frequently cite health care as an area in which competition can generate both greater efficiency and superior service. (The argument is difficult to make for utilities, since they tend to be monopolies, making public regulation essential.) However, claims about the ability of the private sector to improve equity and choice in health care provision are contradicted by considerable evidence about imperfect information and "market failure, such as those arising from the strong power imbalance between providers and patients."[66] Even for contracting out of specific services, an empirical review 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 deign and enforce appropriate contracts with private providers.[67]

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 shaping incentives for public and private providers. There is no "boilerplate" health care contract that a government can easily adapt to its own circumstances.

However, there is growing consensus on several principles about health care provision. 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.[68] 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.

Another area in which competition is supposed to demonstrate the potential of private service provision is electricity generation (as opposed to distribution, which is usually a natural monopoly). When different energy producers are allowed to enter the market, using different kinds of fuel and production processes, customers should benefit through lower prices. However, deregulated energy sectors in a number of localities in highly industrialized countries have been characterized by market manipulation and spectacular price increases. California in the United States and Ontario and Alberta in Canada, could not control electricity prices under a unregulated power market. Regulators in developing countries that promote private sector generation therefore face a daunting challenge.

Fighting corruption

One of the most common justifications for privatizing services is the high level of corruption often evident in government-provided services. However, if there was ever a double-edged sword in the debate over reforming services, corruption is it. Private provision proponents argue that front-line government service providers routinely engage in petty bribery and theft of supplies, and portray high ranking officials as perpetrators of massive graft. They have no shortage of evidence. Skeptics, in turn, can choose from a large and growing menu of non-transparent and criminal practices among firms that deliver essential services. Former World Bank Chief Economist Joseph Stiglitz once memorably referred to privatization as "briberization". This paper draws no conclusions about which is worse. Rather, it proposes that policy-makers assess existing or potential accountability mechanisms as they consider which kind of provider is more likely to serve public welfare.

Neither public officials nor private businesses are inherently honest. If not made accountable to service users, both can engage in the most egregious rent-seeking activities. Information disclosure and external monitoring are therefore essential for both kinds of arrangements. Corrupt governments clean up their act only when they have to answer to citizens. Where policy-makers depend on rent-seeking elites for political survival, or citizens lack the in-

formation they need to evaluate the behavior of those entrusted to serve the public, accountability is hard to deliver. By contrast, private firms refrain from corruption when they have to answer to government. Because they are directly accountable to shareholders, keeping them honest requires, above all, an effective public regulator.

If one accepts the premise that ungoverned profit-maximizing companies are no more philanthropic than their public sector counterparts, then state institutions become the weakest link in fighting corruption *regardless of who the provider is.* What tends to be lost in the debate over service reform is that regulatory integrity is the key to both effective public and private provision.

The 2004 *World Development Report* promotes the perspective of many private provision advocates who seek to "separate the policy-maker from the provider". They argue that when the same government charged with delivering services must also monitor and regulate the service provider, an inherent conflict of interest weakens internal accountability. Accordingly, they maintain that increasing user fees and increasing choice will make consumers less tolerant of poor quality in general, and corruption in particular. Private provision and commercialization thus "empower" consumers and force providers to behave in an accountable manner.

Critics of this perspective, however, respond that there is no substitute for effective regulation when it comes to essential services. Especially for natural monopolies like utilities, the question of choice is moot; regulation is the only way to prevent a variety of market failures, including corruption. Even for competitive services like health care and health insurance, public authority is required to protect consumers from fraud and abuse. Industrialized western countries have created thousands of such regulations and an enormous regulatory apparatus to fulfill this purpose.

Yet even in countries with strong institutions, control over information provides ample opportunity for firms to cheat government and tax-payers. In the United States, the nation's second largest hospital chain paid $54 million to the government to settle claims that doctors at a California hospital performed hundreds of unnecessary heart operations and then billed government insurance programs for reimbursement. In July 2003, a leading medical laboratory in the United States paid over half a billion dollars in fines after pleading guilty to obstructing investigations over its conspiracy to defraud government healthcare programs.[69]

The "privatization paradox" described at the beginning of this paper is especially perplexing when it comes to good governance in developing countries with weak institutions. The same government officials that were too corrupt to deliver services to citizens are expected to be immune to the lucrative inducements of private firms. Public sector managers unable to control the behavior of front-line government agencies must somehow enforce compliance with standards of corporate responsibility.

While public service employees may steal from consumers, supply warehouses and budgets, private providers also have numerous opportunities for corruption and regulatory capture. These include the bidding process for public contracts, the establishment of contractual terms, enforcement of contract compliance (including tariff changes), and anti-competitive collusion. Moreover, the more money is at stake, the greater the potential for corrupt behavior. For example, according to the World Bank itself, "transnational firms headquartered abroad are more likely than other firms to pay public procurement kickbacks."[70] Corporate corruption is not an isolated phenomenon. In the United States, accounting scandals at Enron and WorldComm preceded record-breaking bankruptcies, while energy companies have been implicated in manipulation of the price of electricity in California's deregulated market.[71]

There are countless examples of corruption in privatizations undertaken developing countries.[72] Among the best known is the infamous "loans for shares" scandal in Russia, in which a large proportion of the country's most valuable assets were sold off to political insiders for a fraction of their worth.[73] In Papau New Guinea, the national Ombudsman Commission investigated a Build-Own-Transfer concession to the Malaysian firm JC-KRTA. It concluded that the contract award involved favours from high-level politicians and was based on personal contacts with the government.[74] In Orissa, India, a government-appointed committee reported illegal behaviour on the part of a major private generator, including, non-payment to the transmission company, the refusal to provide concessional pricing arrangements stipulated by the regulatory commission, and non-compliance with regulatory judgments.[75]

Rationale no. 4 – making reform irreversible

One of the most compelling rationales for private provision is that it helps make reforms permanent. The ebb and flow of the political system creates a certain degree of uncertainty. What one reformer accomplishes today may be undone by the next administration. Private provision is thus a useful way to remove policy from the political agenda. It is much easier to increase subsidies or reverse employment cutbacks than to re-nationalize private assets or expel private firms from the market.

Permanence has its attraction, but it is important that only the right reforms be cast in stone. Unfortunately, policy-makers often lack sufficient information and analysis to be able to predict the social and economic impacts of major reforms. In this sense, while making effective reforms irreversible is highly desirable, it would be dangerous to leave no exit door behind for policies that are poorly implemented, have far deeper negative impacts than initially believed, or have major unintended consequences that were not originally considered. Thus, before making decisions that preclude reversal or even significant modification, policy-makers should undertake a focused analysis of expected impacts over time.

One implicit premise underlying the rationale for policy permanence is that the political system is inherently corrupt and responsive to rent-seeking interests. Thus it is better to prevent anyone from making policy changes than allow policy to be constantly subject to manipulation and political calculus. Policy-makers in many countries may have good reason to be sympathetic to such a premise. However, to the extent the existing system excludes the poor, rural people or other marginalized groups from essential services, policy-makers should determine whether any permanent policy alternative is more likely to improve the status quo or lock-in (or deepen) current inequities. Upon reflection, they may conclude that only by directly challenging political elites can government truly advance public welfare.

The most common way that government can tie its own hands in service reform is through privatization or long-term private concessions. Expropriating private property (and to a lesser extent rescinding a legal contract) is typically considered a radical, populist and irresponsible act, especially by investors upon which governments depend to generate jobs and economic growth. Such actions can bring the wrath of multilateral and bilateral lenders, and lead private rating agencies to seriously downgrade sovereign credit risk. Because such pressures can lead to higher interest rates or even a cutoff of credit, private provision can effectively remove government from service provision for the foreseeable future.

Even in cases where it is politically feasible to take back control of essential services, over time private provision may make such an alternative impossible for more practical reasons. Especially when it comes to complex, integrated sectors such as utilities, surrendering the capacity to deliver services may make it impossible for the government to turn back the clock.

> When governments transfer control over their water system to private companies, the loss of internal skills and expertise may be irreversible, or nearly so. Many contracts are long term – for as much as 10 to 20 years. Management expertise, engineering knowledge, and other assets in the public domain may be lost for good. Indeed, while there is growing experience with the transfer of such assets to private hands, there is little or no recent experience with the public sector re-acquiring such assets from the private sector.[76]

Multilateral trading system and services

Governments can also make public service reforms permanent through legally binding constraints. Perhaps the most controversial of these is through the WTO's General Agreement on Trade in Services. (For an overview of the Agreement's provisions, see annex E.) While GATS does not privatize services, it does limits the ability of governments to take actions that affect the competitive position of foreign investors. Therefore the impact of GATS does not derive from the sale or contracting out of public assets, but rather from restriction on government regulation or subsidizing of service providers, especially in ways that provide advantages that might discriminate against an existing or potentially existing competitor.[77]

Once a government has made specific sectoral commitments under the GATS, it may only reverse those commitments by negotiating acceptable com-

pensation with all affected parties – a costly undertaking that virtually ensures continuity. The WTO itself declares that "because unbinding is difficult, [government] commitments [to a sector] are virtually guaranteed ..."[78] This means that if subsequent events reveal serious negative social or economic effects, it may be too late to take corrective action.

While WTO officials routinely deny that GATS applies to basic public services, the ambiguity of existing language suggests otherwise. GATS does exempt those services "supplied in the exercise of governmental authority", but defines those services as being provided neither on a competitive nor commercials basis. Thus for services in which governments compete with private providers or charge cost covering fees, it seems quite plausible that they potentially fall under GATS jurisdiction. Moreover, in the current round of negotiations, northern countries have already made numerous requests for opening up water, electricity, health and education services, making it quite clear that governments are now being pressured to make commitments in essential services that will be fully subject to GATS disciplines.

It is revealing that even as northern governments pressure southern countries to open up their essential service sectors, citizens from these countries, including public service managers, local governments, consumer advocacy and policy research organizations, have mobilized to demand that their government refrain from making irreversible commitments that could undermine government's ability to regulate or subsidize essential services. Indeed, the entire European Union has categorically excluded these services from its GATS commitments.[79]

The WTO and its supporters characterize opponents of GATS as uninformed and alarmist. Yet neither the WTO nor the multilateral lending institutions have prepared a framework for assessing even the economic – to say nothing of the social impact – of opening services under GATS.[80] The argument made here is not that liberalizing trade in essential services is always a bad decision. Rather, it is that policy-makers are fully justified in demanding more information about the consequences of that liberalization before jumping in with both feet.

Many who track WTO processes have observed that it may be impossible to apply tradition "safeguard" measures to GATS commitments. While trade in good in primarily about tariffs and quotas, trade in services is primarily about investment restrictions. A government facing negative balance of payment or employment impacts in manufacturing can temporarily raise tariffs and limit imports. However, it cannot simply stop foreign firms with domestic investments from providing services – even for a limited time.

For many competitive services, safeguards may intractably difficult to implement. Yet for *essential* services whose primary purpose is human welfare, governments should insist on greater flexibility for policy actions that affect foreign investors. One approach might be to create safeguards involving regulation and subsidy allocation – rather than direct expropriation or forced exit – and the development of objective indicators that make it possible to measure negative social impacts from liberalization.

With such a framework in place, it would be possible to specify an impact threshold for applying safeguards, enabling governments to respond quickly with policies that may not be normally WTO-consistent. While foreign investors may dislike any measure that could undermine their competitiveness or profitability, objective social impact indicators would help ensure that safeguards are not hijacked by protectionist interests.

V. Conclusion

While many of the rationales for private provision are compelling, private provision in practice does not always deliver on the benefits associated with those rationales. In some cases, private service delivery results in a fiasco, while in other cases undeniable improvements are evident. However, in many of the latter cases, the economic logic underlying private provision of essential services can exclude or harm poor people, or force the government to assume far costs that rival or vastly exceed those of public sector reform.

Moreover, the benefits of private provision are often most doubtful precisely where public services are performing the worst. Governments that already have strong institutions and accountability mechanisms are likely to be able to implement privatization

policies quite effectively. However, they are also more likely to have effective service providers and low levels of corruption to begin with. On the other hand, rent-seeking public institution and governments driven by special interests typically deliver poor quality services, or limit access to the privileged few. While there may be much room for improvement, such governments offer little hope for properly regulating private firms that deliver services.

Proponents of private provision often assume a "counter-factual of inaction". They compare best-case private provision scenario with continuation of failing public service. The implication in much privatization literature is that government is simply beyond hope. Yet there are often viable options for reforming public services, especially by increasing accountability to citizens, and making budgets more progressive. In many cases, the constraints on these options are starkly political, while in others the need is for greater technical capacity or better organizational incentives. Before committing to private provision, especially with weak regulatory capacity, governments should assess the constraints to "doing privatization right", the costs of doing it wrong, and options for reforming existing public sector services. Toward that end, this paper encourages policy-makers to:

- Determine which *kinds of institutions* are needed for different provision options.
- Assess *the feasibility and time horizon* for strengthening or creating those institutions.
- Evaluate the *risks* of attempting different paths of reforms and ask whether those risks are acceptable.
- Estimate the potential *social and economic costs* of service provision while appropriate institutions are being built.
- Consider a *range of roles* that the private sector might play in essential service.

Most participants in the debate over reforming services may agree with the idea of keeping policy options open until analysis and evidence are available. However, in practice much policy advice leaves room for only limited options within a single, predetermined approach. Yet policy-makers need not have to choose between "all-or-nothing" as they consider alternatives for policy reform.

Pace and sequence are critical. Experience with "big-bang" structural reforms has been disappointing, because the institutions required to make them work are usually not in place. A gradual, cautious approach can help governments avoid big mistakes and also enable learning that translates into subsequent policy action. In the case of essential services, full private sector management (or ownership) of service delivery may suddenly give government with new responsibilities that it is not willing or able to fulfill.

Private provision contracts need not delegate wholesale management of complex services to a single provider. Within the private sector, large corporations contract out specific tasks to smaller firms in order to increase efficiency or production flexibility – while maintaining full control over finished products and services. Similarly, governments may continue to provide essential services directly while using contracts to produce important inputs into final service delivery: e.g., construction, installation of household utility connections, meter reading and bill collection, etc.

For example, there is an important distinction between service contract, which assigns responsibility for isolated tasks, and management contracts, in which "management authority is transferred to the private sector. The more isolated the task, the less risk the private is expected to assume. Privatization advocates point out that service contracts under weak public management are unlikely to result in significant improvement.[81] However, by the same taken, where regulatory capacity is weak, governments are unlikely to enforce private sector compliance with terms of complex and sweeping management contracts.

Weak states therefore present obstacles to both public and private service delivery options. The challenge for policy makers is to determine how to structure and sequence reforms so as to enhance the government capacities needed to make chosen reforms effective. As they begin the reform process, governments can harness the efficiency and incentives or private provision without taking big risks. For example, private firms may bid on delivering specific elements of service delivery to government buyers, rather than delivering the entire service to households.

Particularly where institutions are weak, governments as customers (typically monopsonies) are likely to have far greater ability to hold private firms accountable than individuals. Greater efficiency in these areas may help improve service quality or financial sustainability, thereby contributing to effective public sector reform. Alternatively, as government learns how to monitor and regulate limited private provision activities, it may become better prepared to move on to more advanced stages of private provision.

Annex A

Questions about Foreign Direct Investment

FDI is usually portrayed as an economic blessing that countries should strive to increase. To be sure, a drop in FDI can cause losses in capital, technology and jobs, However, recent evidence reveals a number of limitations to development strategies that prioritize high levels of FDI.

- FDI share is higher in countries with higher quality institutions, suggesting that countries trying to expand their access to international capital markets should concentrate on developing credible enforcement mechanisms instead of trying to get more FDI.[82] There is very little evidence that more open investment regimes or investment protection treaties do much to stimulate foreign direct investment.[83] Rather, foreign corporations appear to be attracted primarily by the prospects of high profits, either from exploiting the domestic market or by achieving cost savings on export production through low wage labour.

- FDI in some sectors can weaken governments vis-à-vis foreign corporations, which can exercise considerable influence over public policy through control of information and management decisions. Chairman of Barclays Capital Chairman Hans Joerg Rudloff – hardly an enemy of capitalism – stated: "I'm not a protectionist, but [some] countries sold their silver spoons to foreign buyers without any safeguard for their national interests. They didn't realize that by selling all of their assets like utilities and their banking industries to foreign investors they moved the entire decision-making power over their economic destiny in their own country to people in other parts of the world."[84] Even as the United States, Europe and Japan seek to open up developing country markets to their corporations, governments in these countries routinely limit the ability of foreign investors to control firms or sectors involved in national security, technology development, financial markets, and essential services.

- FDI can have detrimental effects on the balance of payments. Recent research suggests that levels of FDI stock in developing countries are far higher than currently believed, and that the rates of return on these investments is extremely high. The repatriation of profits reduces net foreign exchange inflows for foreign investment in export sectors. FDI in sectors like essential services can actually undermine the balance of payments. According to economist David Woodward, a former staff member of the office of the Executive Director of the United Kingdom to the World Bank and IMF: "For equity investment and some types of direct investment (especially the purchase of existing productive capacity and new investment in non-tradeable sectors), the net foreign exchange effect will be substantially negative."[85]

Annex B

External pressures for local government austerity

The experience of state-owned enterprises (SOEs) suggests the need for caution when making fiscal arrangements with local governments that deliver essential services. Former World Bank economist John Nellis, now a researcher at the Center for Global Development in Washington, states that commonly: "IMF involvement and surveillance [of the economy] led to a choking off of direct budgetary financing of SOEs ... In response, private sector management, financing or ownership was proposed. The World Bank then became more directly involved in terms of reform/ privatization design, and assistance in implementation."[86] One way that the IMF imposes fiscal discipline on central governments in decentralized countries is to cut back fiscal trans-

fers during periods of economic difficulty. Another is to forbid central governments from bailing out local ones that raise their own resources through borrowing.

An example from Bolivia is illustrative. To help curb instability and foster investment, the IMF and the World Bank may direct governments to promote the development of a municipal credit market. In recent loans, the World Bank required that the Government of Bolivia use revenue intercepts as collateral to municipal credit operations with any lender, and to require municipalities to enter into Financial Restructuring Agreements (FRAs) ensuring that they maintain hard budget ceilings.[87] Such steps are intended to improve the access of municipalities to international financing, by increasing confidence among investors. Seven municipalities entered into FRAs and accepted fiscal targets that were based on the IMF's assumption of 4 per cent GDP growth in 2001. The actual GDP growth rate was only 1.2 per cent. Central government revenues plunged by 26 per cent in 2001 and general transfers from the central to municipal governments were *11 per cent less than projected*. Because municipalities with FRAs were constrained from borrowing; they instituted new local taxes and user fees and carried out cutbacks in programms and staffing.

When appropriate fiscal resources are not provided, decentralization can lead to local services that are segregated by income. In South Africa, after decentralization reform and re-zoning, the municipality of Nelspruit found its population multiplied by a factor of ten in 1994, while its total revenues grew only by 38 per cent. Moreover, most of the new residents were poorer people. These challenges were increased further after the 2000 demarcation process, which doubled the municipality's population of the municipality, while keeping the same tax base. As a result, cash-strapped local government wanted to "wash its hands of responsibility" for water by handing it over to a private concession.[88] In this episode, privatization of water became a convenient political exit strategy for local officials desperately lacking resources. A review of Latin American education reform in four decentralized countries (Mexico, Argentina, Chile and Colombia) revealed severe reductions in public spending (primary teachers' salaries) and a widening of the quality gap between public and private providers.[89] In sub-Saharan Africa, where inadequate fiscal transfers, restricted local revenue raising and poor planning have been the norm, decentralization has led to consistently disappointing results.[90]

Annex C

Multilateral guarantees

Private lenders and investors in infrastructure projects seek to protect themselves from risks by obtaining commercial or political guarantees from export credit agencies, private insurers, and multilateral institutions. Such guarantees shift private sector risk onto taxpayers – precisely the reverse of what privatization proponents promise for greater private sector participation in services. When private firms lend to or invest in a water project in a borrowing country, the Bank's guarantee promises the private firms compensation for certain losses if, under specified conditions, the borrower does not meet its obligations. The MDBs claim that guarantees are indispensable for building confidence and providing the incentive for private financiers to invest in infrastructure projects. Critics argue that such guarantees distort risk calculations and foist unsustainable price, demand, and currency risks upon the government.

The MDBs offer two primary types of guarantees:

- *Partial risk guarantees* cover government obligations spelled out in agreements with the project entity and ensure payment in the case of debt service default resulting from non-performance of contractual obligations undertaken by governments or their agencies in private sector projects.

- *Partial credit guarantees* cover all events of non-payment for a specified part of financing. This helps to extend maturity periods, which is often significant in obtaining longer-term financing for large construction projects.

There is not a clear distinction between political and commercial realms, an ambiguity that creates its own set of problems. As a general rule, however, the commercial side refers to the risks to profits due to production inefficiencies or lack of demand. The political aspect risks refer to those risks over which the government has some measure of power. Miti-

gating political risks involves obtaining government commitments not to expropriate private holding, to protect the investment from consequences of war and unrest. The World Bank guarantees also cover local currency financing.

The World Bank is exploring arrangements that will help sub-sovereign borrowers obtain financing without needing sovereign guarantees. The Swedish International Development Cooperation Agency (SIDA) helped to establish GuarantCo, which will provide partial guarantees on issues of paper by private sector infrastructure service providers and possibly municipalities and/or public sector authorities.

The Bank's issuance of guarantees can constitute a serious conflict of interest. If the bank action to address social or environmental difficulties with privately-financed projects results in the disruption of a project or an escalation of costs, the guarantee could be called. In other words, it could be in the public interest for the Bank to "blow the whistle" on privately-financed projects. However, the Bank would be constrained from taking such action given its liability – namely, the guarantee.

Furthermore, since guarantees are provided by the private sector, it is redundant for the MDBs to offer these products. If projects are not viable, the Bank could be seriously distorting risk calculations by providing extra comfort to investors and lenders. Assuming that the institutions do continue to utilize guarantees, they should use investment screens to ensure that projects meet specified "sustainable development" criteria.

Investment screens have been commonly used by private investors in the United States and other industrialized nations to select the portfolios of Socially Responsible Investment (SRI) funds. An investment screen is a set of non-financial (such as social or environmental) criteria that must be met by all companies in an investment portfolio. There are two kinds of investment screens: "negative screens" which are a set of criteria delineating what characteristics companies in the portfolio cannot have (production of nuclear weapons; operations in Burma; Superfund sites, etc.); and "positive screens", which are a set of criteria delineating what characteristics companies in the portfolio must have.

Annex D

Hubco: Pakistan's power dispute

In its efforts to attract foreign capital to the energy sector, Pakistan developed a policy framework of financial incentives that included a long-term PPA. According to a case study published by the American University, "Investors were reassured that the Water and Power Development Authority (WAPDA) and the Karachi Electric Supply Corporation (KESC) would purchase electricity for a very reasonable 6.5 cents/kwh."

This guaranteed the foreign producer that regardless of a potential drop in demand for electricity, the government would purchase the supply of electricity at a favorable prices. Pakistan's largest power plant in 1997 was Hubco, located about 40 km northwest of Karachi. "The state-owned WAPDA will purchase power from Hubco and the power purchase agreement assures a guaranteed revenue equivalent to 60 per cent of gross capacity utilization, irrespective of the actual takeoff from the power station."[91]

At the time Hubco was going online, the World Bank hailed the arrival of independent power producers as a solution for Pakistan's energy shortage, as well as a way to stem subsidy outlays needed to cover loss-making public generators. However, shortly after operations began, problems resulting from the PPA became apparent. As the Asian Development Bank's Country Director to Pakistan explained:

> With the commissioning of some IPP power plants in 1997, WAPDA and KESC purchased electricity from these IPPs. From 1998, Pakistan had excess capacity with the utilities contracted to purchase expensive IPP electricity while their own plants were underutilized. Faced with the problem of having to purchase power from the IPPs and the two private sector operators - HUBCO and KAPCO at an expensive rate, the Government's financing of other public enterprises in the power sector was adversely affected. The Government contended that the $0.065/kWh rate of the IPPs, as per their agreement with the previous Government, is unaffordable for a country like Pakistan. In 1996 and 1997, WAPDA and KESC faced serious liquidity problems and defaulted on some of their financial commitments.[92]

The year after, the Sharif administration accused Hubco of using deception to influence the former Bhutto government to accept an excessively priced PPA with WAPDA. Although corruption charges were not upheld in court, tariffs were eventually reduced by a significant margin.

The Hubco case not only demonstrates the fiscal problems that PPAs can cause, but also the difficulties of governments lacking experience with complex contracts. Particularly in poor countries characterized by high risk, powerful corporations are in a strong position to demand lucrative contract terms from governments lacking negotiating power and skill. The "take it or leave it" position of a dominant firm can leave a government with no choice but to offer concessions never contemplated in textbooks on economic theory.

Annex E

An overview of the General Agreement on Trade in Services

GATS went into effect as part of the World Trade Organization on 1 January 1995. Its purpose is the progressive liberalization of trade in services under four distinct "modes":

1. *Cross-border supply:* ability of non-residents to supply services within another Member's territory.

2. *Consumption abroad:* freedom to purchase services in the territory of another Member.

3. *Commercial presence:* opportunity for foreign suppliers to establish, operate or expand a commercial entity in a Member's territory, such as a branch, agency, or wholly owned subsidiary.

4. *Presence of natural persons:* permission for entry and temporary stay in the Member's territory of foreign individuals in order to supply a service.

The Agreement calls for successive rounds of negotiation to extend GATS coverage into new service sectors, and to specify rules that affect governments' ability to regulate or participate in those sectors. GATS applies to all WTO members, which are subject to legally binding dispute settlement decisions.

GATS has potentially far-reaching effects, since a wide range of services may fall under its jurisdiction. The Agreement excludes services that are "provided in the exercise of government authority", which means that the service must be provided on *neither* a commercial *nor* a competitive basis. Currently, however, it is difficult to determine the precise scope of the Agreement, since there is a great deal of controversy over these important qualifications.

Once a government has made a commitment under GATS, it can be very hard to reverse. If a government does choose to withdraw from a previous commitment, it must compensate other Members whose service suppliers may be adversely affected. GATS protects foreign service suppliers and investors through several basic rules. Some of these rules apply only when approved by Members for specific service sectors.

- *Most favored nation.* Government must extend any regulation or financial measure that benefits one foreign service provider to all foreign providers. Most-favored nation treatment applies automatically to all sectors unless a member explicitly excludes that sector from the MFN rule.

- *National treatment.* Government must offer "best treatment" of domestic service providers to foreign providers. If competition is altered to favour domestic providers, even as an unintended consequence of promoting domestic social goals, a measure can be ruled as discriminatory. National treatment provisions apply only to sectors in which a country affirmatively lists commitments.

- *Market access.* Government may not restrict the number of service suppliers or employees in a sector, the value of transactions, or the types of legal entities that may supply a service. Like national treatment, market access provisions only apply when a country explicitly makes this commitment in a sector.

- *Monopolies and exclusive providers.* Governments may exercise monopoly for a service sector, but can only do so by listing the sector as a country-specific exception. Governments

that make commitments in this area area cannot use their power in a way that violates MFN, national treatment or market access commitments.

- *Domestic regulation.* Still under negotiation in Geneva, these provisions could create some form of "necessity test" to be applied to regulations such as professional qualification, technical standards and licensing procedures. Regulations determined to pursue non-legitimate objectives or to be "more trade restrictive than necessary" by a dispute settlement panel would not be permitted.

Notes

1 This paper uses the term 'privatization' to connote variants of provision by non-state actors: private firms or non-profit organizations. Private provision refers to control over assets: direct ownership or authority over management, resource allocation decisions. Under private *provision*, the public sector plays primarily a regulatory role. However, many forms of private sector *participation* can exist under direct public provision. Some of these are discussed in the conclusion.

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22 Antonio Estache, Vivien Foster and Quentin Wodon, "Making Infrastructure Reform Work For the Poor: Policy Options based on Latin American Experience", LAC Regional Studies Program, WBI Studies in Development, FPSI, World Bank, 2001, p. 19.

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