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"Why is regulation insufficient? Social policies and private sector participation in water supply"

Naren Prasad[1]

UNRISD

prepared for the UNRISD project on

"Social Policy, Regulation and Private Sector Involvement in Water Supply"

DRAFT WORKING DOCUMENT
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[1] United Nations Research Institute for Social Development (UNRISD), Research Coordinator, prasad@unrisd.org. Anna Sagan provided excellent research assistance for this project.

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UNRISD, Palais des Nations
1211 Geneva 10, Switzerland

Tel: (41 22) 9173020
Fax: (41 22) 9170650
E-mail: info@unrisd.org
Web: http://www.unrisd.org

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Summary

Infrastructure maintenance is one of the biggest challenges confronting the water supply sector in developed and developing countries. In the latter, an additional challenge is to extend the network and thus increase the coverage of the population. Both, network maintenance and network extension require big (and often increasing) investments, but the funding of such investments poses major problems in developed and developing countries alike. The most common solution proposed consists of market-based reform, which includes operating the system on a full cost-recovery principle, commercialisation, or private sector participation (PSP) of various degrees. Given that water is a basic necessity, affordability of the service becomes a major issue. However, the water industry is a natural monopoly and as such it is not free from problems associated with lack of competition regardless of who owns or operates the system. They may include charging higher prices, or lowering production costs by decreasing the quality of service. In such circumstances, government intervention, either through public management or through appropriate regulation is often proposed.

However, previous UNRISD research has shown the shortcomings of concession type contracts and how regulation in developing countries is faced with major challenges, which render it ineffective. Following those findings, our current study demonstrates that in such circumstances, water reform to increase coverage should go in tandem with social policies. Such policies are crucial in ensuring that the vulnerable groups have access to affordable water. Social policies related to water supply are quite common in both developing and developed countries alike, with the most widespread forms being *income support* and *tariff adjustment*. The former are linked to welfare systems, and include housing benefits, charities, tariff rebates, flexible payment methods, connection subsidies, and vouchers. The latter comprise increasing block tariffs, cross subsidies, and special tariffs for low-income households.

This book presents the results of an UNRISD research project on “Social policies and private sector participation in the water supply”. Seven country studies were undertaken for the purpose of our study. These were: Brazil, Burkina Faso, Colombia, Great Britain, France, Hungary, and Malaysia. All these country studies show the shortcomings of PSP and how social policies are crucial in addressing the issues of access and affordability. The choice of social policies varies from country to country. In the two developed countries (France & Great Britain) heavy public investment was used to ensure that everyone had access to piped water. In these countries even with high regulatory capacity, social policies in the water sector are crucial. For example in France, it consists predominantly of ex-post assistance to those who cannot afford to pay water bills, operating a fund for rural water supply, and prohibition of disconnection. British social policies include income support based on property values, subsidies, a ban on disconnections, various forms of social security support and social assistance in paying water bills. In addition, there exists an effective and independent economic regulatory body.

In the case of Colombia, our findings suggest that it is the subsidy that helps the poor to have access to affordable water. In addition, private investment commitments prescribed to the private sector have been useful in increasing coverage. Similarly, in Brazil, the desire to make water supply universal led to heavy investment in the 1970s and effective social policies (cross subsidies) helped to increase the coverage to the poor. However, the current impasse on who has the right to grant

concessions (the state or municipality) to the private sector is jeopardizing further progress. The government in Hungary provides subsidies to the regions that have high cost of production. In addition, industrial users cross-subsidize domestic consumption and income transfers by central or local authorities shoulder certain burden on water expenditures of households. The tariffs are kept low ("hidden social policy"), and no disconnection is allowed due to non-payment of bills. The private sector has increased efficiency in the system, but the investment is financed by the state. In Malaysia, the social policies that are in place comprise state financing of water supply in rural areas, cross-subsidy (industrial users to domestic), and lifeline block tariff. In addition, the private sector is contractually obliged to increase the coverage in the urban and rural areas. In Burkina Faso, although the efficiency of the network has substantially improved with commercialisation through PSP, it is putting pressure on dismantling social policies.

Unfortunately, despite having some creative social policies aimed at increasing access and improving affordability, most developing countries have not managed to increase coverage. For example only 38% of the residents in the Ouagadougou (Burkina Faso) have access to piped water, a considerable share of the poorest still lack access to safe water supply in Brazil, Colombia and Malaysia.

1. Introduction

The most important challenges facing the water sector in both developing and developed countries relate to the following (Hall 2001):

- Infrastructure: reducing leakages, replacement/expansion of networks, technological innovation
- Financial: sustainable and equitable tariffs, efficient revenue collection, investment
- Environment and health: public health needs, conservation, environmental management
- Socio-political: having affordable price, transparency, accountability, expansion of coverage
- Managerial: improving efficiency and productivity, capacity building, efficient procurement.

One way to tackle these challenges is through the private sector participation (PSP). PSP in the water industry is one of the most controversial and emotional debates of the current development discourse. On one side are the proponents who argue that since governments have failed in delivering quality water to everyone, the private sector can solve this problem by using market principles. In other words, private sector can improve efficiency, extend the coverage of service, bring in more investment, and relieve governments from budget deficits. On the other side of the spectrum are those who consider that water is a common good and should not be in the hands of the private sector. They argue that since water is unlike any other resource and because of the fact that water is the essence of life, it should not be treated like another commodity and market principles should not be applied to it. In other words, private sector cannot apply just criteria for this merit good. In this context, access to water for everyone becomes a human right and it is the State's obligation to provide this vital resource to everyone. And then there is another group who stands in between these two extreme positions. This group thinks that solutions can be found by considering water as an economic good and a human right at the same time. It is within this context that the current debate is taking place.

PSP in urban water supply has had a long history. Private initiatives were instrumental in establishing modern water supply systems, which led to privately owned or operated systems. This started as a result of urban growth since the mid-1800s in most of the European countries and in North America. England was the precursor of modern water supply systems, which later spread to Germany, elsewhere in Europe and to the United States. However, during the late 19th century, as a result of their unsatisfactory performance (inefficiency, high costs and in some cases corruption) or due to public health concerns in numerous European countries, many of these services were transferred to public or municipal ownership. Today, in the European countries, the provision of urban water supply is quite diverse, ranging from no private sector participation (the Netherlands), PSP but with no profit motive (Austria, Denmark, and Sweden), to an amalgam of PSP arrangements (Belgium, Finland, France, Germany, Greece, Italy, Spain), and to full privatisation (England and Wales) with strong regulation (Mohajeri, Knothe et al. 2003).

Privatisation has been back on the agenda since the late 1970s. During the early 1990s, many developing and transition countries[2] involved the private sector in their water supply. A variety of forms were adopted, ranging from build-operate-transfer (BOT) models, management, service or lease contracts, concessions (the most common), and joint ownership (but rarely a complete privatisation, as in the case of England and Wales or some cities in Chile).

During the last 5 years, there has been a decline in private sector investment in the water sector in developing countries. In addition, an intense and heated debate is taking place on the appropriate roles of the private sector in the delivery of water supply services (polarized around ideological grounds). This has led to an impasse among the stakeholders on how to proceed.

What is required is a constructive engagement. In order to move forward, an independent and balanced multi-stakeholder assessment of the impacts of public and private sector participation is needed. Lessons from the past experiences should help in policy making. This is precisely what this research tries to accomplish: we use seven case studies with extensive statistics on access and affordability to investigate the impact of private sector participation on the poor and how social policies are designed to help them.

2. Research objectives and theoretical framework

Market-based reforms, including privatization have encountered considerable challenges and failures, and especially so in developing countries. This led policy makers to focus on regulation. It was argued that in natural monopolies, such as the water industry, where competition was difficult the state should set up regulatory institutions: coherent, accountable, transparent, and predictable independent bodies (Kessides 2004). They should have the capacity to protect consumers, investors, and the environment. Scholars like Buchanan (1972), Newbery (1999), Laffont (2000) have argued that regulatory process is often captured by interest groups while others like Stiglitz (1998) have argued that regulation is captured by the politicians. Recent research has shown that building independent regulatory institutions in developing and transition economies presents a major challenge and the results have been rather disappointing (see for example Kirkpatrick and Parker (2004), Jalilian, Kirkpatrick et al. (2007), Minogue and Carino (2006), Amann (2006), Cook and Mosedale (2007)). This was a result of poor accountability, deficient transparency and lack of consistency in developing countries (Parker 1999). Similarly, previous UNRISD research has shown that regulation of water services through independent bodies has encountered difficulties in many developing countries (Ugaz 2006). This is a result of poor tradition of independent policy making bodies, weak institutions and uneven bargaining power among the stakeholders. Lack of effective and transparent regulation hampers the accountability of any service provider. This takes us back to square one: *plus ça change, plus c'est la même chose*. In this circumstance, the

[2] Based on World Banks's private participation in infrastructure (http://ppi.worldbank.org) the following countries have involved the private sector in their water supply: Argentina, Armenia, Azerbaijan, Barbados, Belize, Bolivia, Brazil, Bulgaria, Central African Republic, Chile, China, Colombia, Croatia, Cuba, Czech Republic, Ecuador, Egypt, Estonia, Gambia, Guyana, Honduras, Hungary, India, Indonesia, Jordan, Kazakhstan, Lebanon, Malaysia, Mexico, Morocco, Mozambique, Namibia, Niger, Panama, Papua New Guinea, Peru, Philippines, Poland, Romania, Russian Federation, Saudi Arabia, Senegal, Slovak Republic, South Africa, Thailand, Trinidad and Tobago, Turkey, Uganda, United Republic of Tanzania, Uruguay, Venezuela, Viet Nam, West Bank and Gaza.

question that merits to be asked is how to reform the water sector in order to increase coverage?

This research was intended to study how and why social policies can ensure an affordable access to water while independent regulatory instruments are still being developed. The following questions were addressed: How do social policies address issues of affordability and access? What is the role of tariffs (social tariffs, increasing block tariffs, metering)? How are policies designed to help the poor (minimum service levels, subsidies)? Are the poor able to benefit from the social policies in place? And more generally, how can private sector be made to serve poor customers?

In other words, this research investigates the impact of PSP in water supply through the social policy framework. By a social policy we mean any policy put in place by the government or its bodies for the betterment of the welfare of the population, especially its less privileged members. According to Mkandawire (2006), "*Social policy is a state intervention that directly affects social welfare, social institutions and social relations. It involves overarching concerns with redistribution, production, reproduction and protection and works in tandem with economic policy in pursuit of national social and economic goals*" (p. 1). Such policies are also based on the notion of *equity*, which addresses concerns of justice, equality, and rights. Equity here implies a distributional principle, which is applied in the allocation of services and benefits in order to achieve what is considered as just and fair division.

A legitimate question that needs to be addressed is: what is the relationship between social policy and regulation? There is much ambiguity when defining regulation since it depends on whether an economist, a lawyer, a political scientist or a social scientist defines it[3]. In the case of PSP in the water sector, regulation often refers to a diverse set of instruments by which *governments* through an independent agency protect consumers, investors and environment. It includes laws, orders and rules issued by all levels of government and by non-governmental bodies to whom governments have delegated regulatory powers. In this view regulation not only means creating institutions, but also defining the "rules of the game" (Minogue 2005) (Kirkpatrick and Parker 2004). In other words, "*regulation refers to the promulgation of an authoritative set of rules, accompanied by some mechanism, typically a public agency, for monitoring and promoting compliance with these rules*" (p. 3) (Baldwin, Scott et al. 1998). In this sense regulation refers to all the efforts of state in order to promote the welfare of its citizens, including economic, fiscal or redistributive policies. Our definition of social policy comes close to regulation, except for the requirement of having an independent regulatory institution. It is widely recognized that having such an independent agency in place is difficult in developing and transition economies. Therefore we argue that an additional set of (social) policies