successful reforms have arguably one common feature: instead of trying to fix an entire set of dysfunctional institutions, as most failed reforms do, they simply bypass them. These 'institutional bypasses' can be an effective way of overcoming the three traditional obstacles to institutional reform proposed by Trebilcock and Daniels:[33] lack of financial, human or technological resources; social–cultural–historical factors; and political economy-based impediments. Moreover, it may help reformers to deal with the high levels of uncertainty related to the effects of reforms caused by institutional interconnections and path dependence-related factors.

Like coronary bypass surgery, in which transplanted blood vessels are used to create a new circulatory pathway around clogged or blocked vessels, an institutional bypass creates new pathways around ineffient or dysfunctional institutions. Unlike other procedures that try to unblock clogged arteries or expand narrow ones, the coronary bypass simply ignores the existence of the unhealthy artery and creates a new pathway for blood flow. One example of an institutional bypass is a bureaucratic reform in Brazil called *Poupatempo* (Saving Time).[34] In 1997, the government of the state of São Paulo created a one-stop shop for bureaucratic services. In contrast to the pre-existing system, in which government services were accessed by the public at multiple service points, offices of the federal, state and, in some cases, local administration were placed in one location in order to provide easy access to a variety of services. Services were provided more quickly than within the pre-existing bureaucracy, disrupting entrenched institutional cultures.

Poupatempo became the main provider of governmental services within the state shortly after its creation. In 2007, it provided services to an average of 50000 people a day in the state of São Paulo. In that year, 18 units together serviced 23 million people. *Poupatempo* is an example of a successful institutional bypass because it created a new pathway for the provision of the same services that were being provided by the existing bureaucracy, but in a more efficient fashion.

change', *Brazilian Political Science Review* (forthcoming 2011); Mariana Mota Prado, 'Institutional bypass: an alternative for development reform', available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1815442; see also Thomas Heller, 'An immodest postscript', in Erik Jensen and Thomas Heller (eds), *Beyond Common Knowledge: Empirical Approaches to the Rule of Law* (Palo Alto, CA: Stanford University Press, 2003).

[33] Michael Trebilcock and Ronald Daniels, *Rule of Law Reform and Development: Charting the Fragile Path of Progress* (Cheltenham: Edward Elgar, 2008). For a summary, see Chapter 2, section IV, Reasons for the Chronically Poor Quality of the Rule of Law and Related Legal Institutions in Many Countries.

[34] Prado and Chasin, *supra* note 32.

E. Decentralization

Another line of thinking in much of the recent public service reform literature emphasizes the virtues of formal decentralization of government functions to sub-national levels of government (regional or local). This is based largely on the theory that decentralization moves the state closer to the people and renders it more responsive to local needs and preferences. While this, in principle, may be true, experience suggests that implementing decentralization strategies poses major design challenges.

First, a careful identification of functions that are better performed at the local rather than national level needs to be determined so as to minimize inter-jurisdictional spillovers (negative or positive externalities) which risk promoting local policies that may be at variance with or antithetical to the national interest. Such spillovers are likely to be pervasive in areas such as infrastructure, health care, education, law and order, and environmental degradation, rendering an appropriate division of power between national, regional and local governments a major challenge.

Second, once a division of functions is determined, a reallocation of financial capacity, commensurate with the reallocation of functions, is required. On the one hand, decentralizing functions without decentralizing financial capacity is likely to degrade the quality of services offered at the local level and is likely to require some form of fiscal equalization to ensure that all regions have reasonably equivalent capacity to deliver basic public services. On the other hand, decentralizing functions and decision-making authority without clearly defined and stable caps on the central government's fiscal responsibilities – through transfers or subsidies, or explicit or implicit guarantees of borrowings by sub-national levels of government – is likely to encourage fiscal irresponsibility by sub-national levels of government, as well as macroeconomic instability.

Finally, if decentralization fails to increase local citizens' influence over the public sector, the principal benefits of decentralization will be lost. One of the key determinants of local accountability is the system for electing local officials – governors, mayors and members of sub-national legislatures. Where these regimes of accountability are deficient, decentralization may simply lead to more clientelism, patronage and outright corruption (an outcome, unfortunately, too often borne out by experience).[35] As Atul

[35] See William Dillinger and Marianne Fay, 'From centralized to decentralized governance' (1999) 36 *Finance and Development* 19; World Bank, *World Development Report: 1999–2000: Entering the 21st Century* (New York: Oxford University Press, 1999) Chapter 5; see also 'Bringing the state closer to the people' (1997) *World Bank World Development Report*.

Kohli points out in an insightful recent paper on state capacity for development, countries like India and Brazil often possess competent national bureaucracies – or at least apex economic bureaucracies – but state or local government functions, including the provision of infrastructure and basic education and health care, are often mired in incompetence, corruption, patrimonialism or excessive influence by wealthy local elites (explaining, in part, high levels of inequality in access to these services.)[36]

F. Building on Social Capital

A variant on formal decentralization strategies is to emphasize the potential for informal collaborative arrangements between the public and private sectors – in particular the realization of synergies between contributions by government and those by community or civil society organizations (intermediaries between government and individual citizen) that are able to deploy significant forms and levels of 'social capital' amongst their members in collaborative enterprises for mutual benefit. Peter Evans argues[37] that synergies may be realized because of the differences in comparative advantage between the state and civil society organizations in the provision of different inputs to joint projects and the greater potential for embeddedness that such projects permit in terms of civil servants engaging with the concerns of local communities.

By way of examples, Evans points to successful cases of rural irrigation project developments in Taiwan, condominium sewer developments in urban areas of Brazil, and some of Tendler's case studies (for example, her study of the provision of agricultural extension services), as well as the dense public sector–private sector business networks that are often claimed to have been important ingredients in the industrialization of the high performing East Asian economies. Tendler also argues that, from this perspective, public sector unions can be seen in a more sympathetic light than they are often portrayed in the development literature, where they

[36] See Atul Kohli, 'State capacity for development', United Nations Development Program, Global Event Working Paper, 2010.

[37] Peter Evans, 'Government action, social capital and development: reviewing the evidence on synergy' (1996) 25 *World Development* 1119; Peter Evans, *Embedded Autonomy – States and Industrial Transformation* (Princeton, NJ: Princeton University Press, 1995); see also Michael Woolcock, 'Social capital and economic development: towards a theoretical synthesis in policy framework' (1998) 27 *Theory and Society* 151; Christiaan Grootaert and Thierry van Bastelaer (eds), *The Role of Social Capital in Development: An Empirical Assessment* (Cambridge and New York: Cambridge University Press, 2002).

are often seen as self-interested defenders of a dysfunctional status quo in public administration.

However, the East Asian example (amongst others) provides some basis for caution in assigning an indiscriminately large role to civil society in the development equation. What was once seen as an important strength of governments in the high-performing East Asian economies – that is, extensive public sector–private sector networks – quickly became derided by many commentators during and after the Asian financial crisis in the late 1990s as symptomatic of 'crony capitalism' – patronage and corruption in the allocation of credit, licences and government contracts.[38]

IV. PUBLIC ADMINISTRATION AND THE LEGAL SYSTEM

While perhaps not as obvious as the design of legal or political institutions and related constitutional frameworks, law and legal institutions do, in fact, play an important part in structuring the public administration in most countries. Public sector employment laws and collective bargaining regimes, grievance procedures, anti-discrimination laws (often enforced by courts, arbitral bodies or specialized human rights agencies), and specialized administrative agencies charged with overseeing recruitment and promotion (such as public service commissions) all play a central framework role in structuring the performance of a country's public service. Any major set of reforms to the public service must address reforms to this legal framework. In the case of specialized administrative agencies performing regulatory functions (discussed in Chapter 2), administrative law principles and judicial review have a large area of potential application in ensuring transparency, impartiality and due process in their functioning.[39]

V. CORRUPTION AND DEVELOPMENT

Corruption affects most countries around the world but the problem is especially acute, and indeed pervasive, in many developing countries. The cost of corruption is high for developing countries, because it has a

[38] See, e.g., David C. Kang, *Crony Capitalism: Corruption and Development in South Korea and the Philippines* (Cambridge University Press, 2002).

[39] See Susan Rose-Ackerman, *From Elections to Democracy: Building Accountable Government in Hungary and Poland* (Cambridge and New York: Cambridge University Press, 2005).

negative impact on a country's economy (impairing growth), its politics (affecting governmental regulation and policy decisions), its international relations (affecting FDI and diverting foreign aid from its intended purposes), and its society (worsening the distribution of wealth). The World Bank has identified 'corruption as among the greatest obstacles to economic and social development'.[40]

Corruption is a complex phenomenon, but academic research has shown that some of the most important underlying causes of corruption are institutional.[41] Based on this assumption, we assess the prospects for anti-corruption reforms. Given that corruption is yet another institutional factor that prevents development, it poses similar challenges to other institutional reforms analysed in this book: it requires a complex plan of action, which must be adapted to the particular circumstances of each country, and needs to take into account institutional interdependencies, self-reinforcing mechanisms that generate path dependence and political economy problems.

A. Defining Corruption

Although there are many definitions of corruption, we use the term to refer to 'the use of public office for private gain' – that is, corruption of or by public officials (political or bureaucratic).[42] This includes both 'behaviour which deviates from the normal duties of a public role',[43] and 'the violation of the formal rules governing the allocation of public resources'.[44] However, in some countries there may be a lack of formal rules governing official behaviour, or the normal duties of an official may include behaviour that would qualify as corruption in other countries, such as accepting gifts. This complicates comparison between countries.[45]

[40] World Bank, 'Overview of anti-corruption', available at http://go.worldbank.org/K6AEEPROC0.
[41] Susan Rose-Ackerman, *Corruption and Government: Causes, Consequences, and Reform* (Cambridge, UK: Cambridge University Press, 1999) at 226.
[42] Cheryl W. Gray and Daniel Kaufmann, 'Corruption and development' (March 1998) 35 *Finance and Development* 1; Pranab Bardhan, *Scarcity, Conflicts, and Cooperation: Essays in the Political and Institutional Economics of Development* (Cambridge, MA: MIT Press, 2005) at 138.
[43] Joseph Nye, 'Corruption and political development: a cost–benefit analysis' (1967) 61 *American Political Science Review* 2.
[44] Mushtaq H. Khan, 'Patron-client networks and the economic effects of corruption in Asia' (1998) 10:1 *European Journal of Development Research* 15–39.
[45] Michael Johnston and Arnold J. Heidenheimer, *Political Corruption* (New Brunswick, NJ: Transaction Publishers, 2001) at 26.

Generally, corruption entails an 'exchange of government property for personal gain'.[46] More often than not, economic gains are the goal of corrupt behaviour, but the term can also encompass the use of public office to obtain non-economic gains (political or personal). Although corruption comes in many forms, the common element is that an agent (usually a government official) pursues personal gain by bargaining away an item or benefit over which he or she has discretion, but which belongs to a principal (usually the public).[47] It is this principal–agent relationship that gives rise to opportunities and incentives for corruption.

Two of the most important types of corruption for economic gain are embezzlement and bribes. While embezzlement entails the misappropriation of public funds, bribes, in contrast, involve the appropriation of private funds by public officials. Officials might ask for bribes to perform their functions (for example, a city official asking for money to issue a permit that a citizen would otherwise be entitled to), not to perform their functions (for example, a police officer asking for money not to issue a ticket to the driver of a speeding vehicle), or not to perform acts that are not part of their functions but which they can threaten to perform through abuse of power (for example, a police officer asking for money not to torture a prisoner, or a tax official demanding a bribe to forego an audit). Decisions can be 'sold wholesale, as when government policies are distorted to benefit a specific interest group who has bribed policymakers . . . or retail, as is the case when public employees personally collect a payment for the granting of a permit or a license'.[48]

Forms of corruption that involve non-economic benefits, clientelism or patronage take place where public resources and political processes are manipulated to increase personal power.[49] This entails a political exchange between a politician or public official, the 'patron', who gives patronage in exchange for the vote or support of a 'client'. This is a form of 'institutional corruption', which generates gains in a way that benefits officials in their capacity as public officials rather than in their personal life (individual corruption).[50] For example, an elected official may offer high-ranked

[46] Andrei Shleifer and Robert W. Vishny, 'Corruption' (1993) 108:3 *Quarterly Journal of Economics* 1.
[47] Moses Naim, 'Corruption eruption' (Summer 1995) *Brown Journal of World Affairs*, 2: 2: 245–61.
[48] Ibid.
[49] Luis Ronniger, 'Political clientelism, democracy, and market economy' (2004) 36 *Comparative Politics* 3.
[50] Michael Johnston and Arnold J. Heidenheimer, *Political Corruption* (New Brunswick, NJ: Transaction Publishers, 2001) at 42.

and well-paid jobs in the bureaucracy in exchange for political support, rather than hiring based on merit.[51]

When patronage is applied to personal relationships, often referred to as 'nepotism', it results in personal gains for elected officials who use public office to provide benefits and grant privileges to people with whom they are personally affiliated in some way. In this case, public office is used to create benefits for people who belong to a particular social network to which a public official also belongs (extended family, political party or ascriptive group, such as clan, ethnic or religious group).

B. Measuring Corruption

The absence of an authoritative and universally applicable definition of what constitutes corruption limits the development of a measurement tool. This is further complicated by the absence of 'direct, simple and easily contrastable indicators'. Because it is a clandestine activity, corruption measurement requires 'much more elaborated constructions, subject to complex and, often, subjective inputs'.[52] Another problem is that the collection of data only started with the relatively recent attention to corruption in the development literature, resulting in an absence of data from before 1980.[53] Thus, there is limited capacity to analyse how corruption has evolved over longer periods of time.

Most assessments of corruption use one of three methods: (i) gathering the perceptions of stakeholders and individuals; (ii) national institutional profiles which function as a proxy for corruption (budget management or procurement practices), and (iii) auditing individual projects as a sample of likely national practices. None of these assessments are direct measures of corruption. The most direct corruption indicators gather survey information on the real experiences of individuals and businesses of corruption and paying bribes.[54]

[51] James A. Robinson and Thierry Verdier, 'The political economy of clientelism' (2003) Center for Economic Policy Research Discussion Paper No. 3205.

[52] Francisco Javier-Urra, 'Assessing corruption – an analytical review of corruption measurement and its problems: perception, error and utility' (May 2007), Edmund A. Walsh School of Public Service, Georgetown Washington. Available at http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN028792.pdf.

[53] Andrew Williams and Abu Siddique, 'The use and abuse of governance indicators' (2008) *Economics of Governance* 9.

[54] See, e.g., M. Seligson, 'The impact of corruption on regime legitimacy: a comparative study of four Latin American countries' (2005) 64 *Journal of Politics* 408.

The most recent development in corruption measurement is the emergence of 'second-generation'[55] or 'aggregate indicators'[56] which combine several primary measurements. The most widely used measurements are the Corruption Perception Index, developed by Transparency International, and two indices developed by the World Bank: the Business Environment and Enterprise Survey and the World Governance Indicators (WGI).

The Corruption Perception Index incorporates a list of sources which have undertaken their own assessments of levels of corruption, such as the World Business Environment Survey or Freedom House, which are each given a weighting to yield an average corruption ranking. The major advantage of these indices is that they take an average rating, therefore avoiding biases in individual sources and measurement errors.[57] For example, the WGI expresses its rankings with larger confidence intervals for countries for which they have fewer primary sources. Sources are also weighted on the strength of their correlation to each other, although this has been criticized by Arndt and Oman for assuming that similarity in measurement results show higher levels of accuracy, rather than simply sharing the same errors.[58]

Criticisms of these measures reveal the complicated challenge of measuring corruption. These measures primarily focus on expert assessments, such as elite business panels, rather than local household or business sector perceptions. They have been criticized for excluding the experiences of the poor or the informal sector, while focusing too heavily on the perspectives of multinational organizations.[59] Further, a significant gap has been found between perceptions and actual levels of corruption.[60] Perceptions have been found to overestimate local experiences of corruption when compared to survey evidence of real experiences of

[55] M. Johnston, 'Measuring the new corruption rankings: implications for analysis and reform', in A.J. Heidenheimer and M. Johnston (eds), *Political Corruption: Concepts and Context* (New Brunswick, NJ: Transaction Publishers, 2001).

[56] D. Kaufmann, A. Kraay and P. Zoido-Lobatón, 'Aggregating governance indicators' (1999) World Bank Policy Research Working Paper No. 2195.

[57] D. Kaufmann and A. Kraay, 'On measuring governance: framing issues for debate', Issues Paper for 11 January 2007, Roundtable on Measuring Governance, World Bank Institute and the Development Economics Vice-Presidency of the World Bank.

[58] C. Arndt and C. Oman, *Uses and Abuses of Governance Indicators* (Paris: OECD, 2006) at 58.

[59] Williams and Siddique, *supra* note 53.

[60] D. Donchev and G. Ujhelyi, 'Do corruption indices measure corruption?' Working Paper, Economics Department, Harvard University, 2007.

corruption.[61] However, even if more objective data regarding government practices is used, it is still likely to obscure the real situation because of the difficulty of obtaining accurate measurements of a secret activity.

C. Consequences of Corruption

Transparency International has declared that 'in low-income countries, rampant corruption jeopardizes the global fight against poverty, threatening to derail the UN Millennium Development Goals (MDGs)'.[62] How does corruption negatively affect development prospects? To answer this question, it is important to distinguish between different kinds of corruption. First, the misappropriation of public funds for private use has a clear and direct effect on the amount of government finances available to be spent on development-related projects and services. Bribes, in contrast, raise more complicated questions.[63]

In the past, some authors have suggested that bribery can positively influence government functioning and development. Bribes have been considered to be supplementary to a bureaucrat's salary, and thus are similar to the government raising taxes and increasing the remuneration of public servants.[64] This would be especially true if bribes are being paid for these servants to perform their functions or to overcome bureaucratic hurdles (a form of piece-work or performance-based compensation).[65] Some scholars have argued that using bribery to fund the bureaucracy instead of taxes may reduce the tax burden paid by businesses that do not use the government service calling for these bribes, and these lower taxes may be beneficial for growth.[66]

---

[61] Mireille Razafindrakoto and François Roubaud, 'How far can we trust expert opinions on corruption? An experiment based on surveys in francophone Africa', in *Global Corruption Report* (Transparency International, 2005).

[62] Transparency International, 'Press kit: persistently high corruption in low income countries amounts to an ongoing humanitarian disaster', 23 September, 2008, available at http://www.transparency.org/policy_research/surveys_indices/cpi/2008.

[63] Gray and Kaufmann, *supra* note 42.

[64] Beatrice Weder, 'Institutions, corruption, and development and their ramifications for international cooperation', in Hans van Ginkel, Brendan Barrett, Julius Court and Jerry Velasquez (eds), *Human Development and the Environment: Challenges for the United Nations in the New Millennium* (New York: United Nations University Press, 2002) 149–59.

[65] Of course, it would not be equivalent if the bribe was being paid to stop acts in which officials are abusing their powers and positions, such as police officers who ask for bribes not to torture prisoners.

[66] G.S. Becker and G.J. Stigler, 'Law enforcement, malfeasance, and compensation of enforcers' (1974) 3 *Journal of Legal Studies* 1.

It has also been claimed that bribery can help to overcome institutional shortcomings and foster efficiency. For example, Huntington has argued that bribery could enhance efficiency by 'oiling' the ineffective mechanisms of a poorly functioning government, thus improving governance through an informal mechanism.[67] Bribes have also been described as an allocative mechanism that allows for a kind of bidding contest for government services, which may result in an efficient allocation of resources.[68] As Bardhan explains:

> In the context of pervasive and cumbersome regulations in developing countries, corruption may actually improve efficiency and help growth. Economists have shown that in the second-best world with pre-existing policy-induced distortions, additional distortions in the form of black-marketeering and smuggling might actually improve welfare, even when some resources might have to be spent in policing such activities. (. . .) As non-economists usually point out, corruption is the much needed grease for the squeaking wheels of a rigid administration.[69]

These arguments in favour of bribery are not persuasive. A major difference between taxes and bribery is the cost of keeping corruption secret to avoid detection and punishment, with the result that corruption is more distortionary than taxation.[70] There is also evidence that suggests that the cost of capital for organizations tends to be higher where bribery is more prevalent.[71] Moreover, there is a high degree of uncertainty in corruption practices: a private party will never be sure if a corrupt official will keep

---

[67] Samuel P. Huntington, *Political Order in Changing Societies* (New Haven: Yale University Press, 1968).

[68] An example of this type of argument was made by Nathaniel Leff, 'Economic development through bureaucratic corruption' in Monday U. Ekpo (ed.), *Bureaucratic Corruption in Sub-Saharan Africa* (Washington DC: University Press of America, 1979) at 329: 'Corruption may introduce an element of competition into what is otherwise a comfortably monopolistic industry . . . [and] payment of the highest bribes [becomes] one of the principal criteria for allocation . . . Hence, a tendency toward efficiency is introduced into the system.' Similarly economist Francis Lui has asserted that 'bribing strategies . . . minimize the average value of the time costs of the queue . . . [and the official] . . . could choose to speed up the service when bribery is allowed': Francis Liu, 'An equilibrium queuing model of bribery' (1985) 93 *Journal of Political Economy* 760.

[69] Bardhan, *supra* note 42 at 139–40.

[70] Ibid., at 146.

[71] Daniel Kaufman and Shang-Jin Wei, 'Does "Grease money" speed up the wheels of commerce?' (December 1999) World Bank Policy Research Working Paper No. 2254.

his promises. The negative impact of bribes on economic development was first demonstrated empirically by Mauro in his 1995 paper 'Corruption, country risk and growth'.[72] In a business environment with substantial unpredictable costs, businesses will be reluctant to invest. The more variable the rates of corruption, the more negative the effect on foreign investment.[73] Instead, public investment is often increased, as larger budgets and bureaucratic structures of government provide more ample opportunities for corruption and misappropriation.[74] The argument that claims that corruption is efficiency enhancing assumes that red tape is an exogenous factor, and ignores the fact that bribes might become an incentive for the creation of pervasive and cumbersome regulation, thus exacerbating rather than solving the problem of inefficient governance.[75] Corruption may create incentives to preserve the existence of a burdensome regulatory framework, given that interest groups that benefit from the status quo will resist any type of reform aimed at reducing red tape.

Empirical evidence shows that in countries where bribery is common the amount of time private enterprise representatives spend with public officials is higher than in less corrupt countries, reflecting an inefficient use of resources that are wasted on courting political connections.[76] Moreover, those best able to utilize bribery are often not the socially optimal service recipients:

> [t]he grease argument is particularly troublesome in this context [where laws and regulations serve productive social objectives, such as building codes, environmental controls, and prudential banking sector regulations] since bribes can override such regulations and cause serious social harm, such as illegal logging of tropical rain forests or failure to observe building codes designed to ensure public safety.[77]

Corruption negatively affects the ability of the government to regulate market activity effectively by distorting the decision-making process of

[72] Mauro, *supra* note 10.

[73] S.-J. Wei, 'Why is corruption so much more taxing than tax? Arbitrariness kills' (1997) National Bureau of Economic Research Working Paper 6255 (Cambridge, MA).

[74] V. Tanzi and H. Davoodi, 'Corruption, public investment, and growth'(1997) International Monetary Fund Working Paper, 97/139.

[75] Vito Tanzi, 'Corruption around the world: causes, consequences, scope and cure' (1998) 45 *IMF Staff Papers* 4; Gray and Kaufmann, *supra* note 42 at 8; Bardhan, *supra* note 42 at 141.

[76] Raymond Fisman and Roberta Gatti, 'Bargaining for bribes: the role of institutions' (2006) Discussion Paper No. 5712, CEPR.

[77] Gray and Kaufmann, *supra* note 42 at 8–9.

government officials. Anti-corruption detection and punishment efforts are also costly for the state. Finally, the distributive effect of corruption is negative: while a tax system can have progressive features, bribes are likely to exclude the poor from the bribery system altogether, increasing inequality and perpetuating vested interests. Corruption increases levels of inequality by limiting access to beneficial government activities to an already privileged group.[78] In sum, corruption is a major obstacle to development. However, it is not fully clear whether causality between corruption and development runs in only one direction. Corruption can reduce the GDP per capita, but at the same time poorer countries have fewer resources to fight corruption, and the lack of resources creates more incentives to be corrupt,[79] which suggests that growth may reduce corruption.

D. Causes of Corruption

Corruption has not always been a prominent issue on the development agenda. Until recently, there was resistance to discussing the prevalence of corruption in developing countries because this could suggest that it was part of the culture of these countries – a claim that could be perceived as racist, discriminatory or morally patronizing.[80] Some studies have linked levels of corruption to such factors as more hierarchical social structures or social embeddedness, which can be detrimental to individual civic engagement – a factor which should help to reduce corruption.[81] Although culture may not be able to explain fully the presence of corruption in developing countries, it is clear that reforms targeting corruption must take cultural factors into account.[82]

The importance of culture has been documented in a recent study by

[78] For a pioneering study, see Mauro, *supra* note 10. For an extensive review of the literature, see Johann Graf Lambsdorff, 'Consequences and causes of corruption – what do we know from a cross-section of countries?', in Susan Rose-Ackerman (ed.), *International Handbook on the Economics of Corruption* (Northampton, MA: Edward Elgar Publishing, 2006).

[79] Ibid.

[80] Robert Klitgaard, *Controlling Corruption*, (Berkeley: University of California Press, 1988) at 208–9.

[81] Rafael La Porta, Florencio Lopez-De-Silanes, Andrei Shleifer and Robert W. Vishny, 'The quality of government' (1999) 15:1 *Journal of Law, Economics and Organization* 222–79; Lambsdorff, *supra* note 78; Amir Licht, Chanan Goldschmidt and Shalom Schwartz, 'Culture rules: the foundations of the rule of law and other norms of governance' (2007) 35 *Journal of Comparative Economics* 659.

[82] B. Husted, 'Wealth, culture, and corruption' (1999) 30:2 *Journal of International Business Studies* 339–60.

Raymond Fisman and Edward Miguel.[83] They measured how likely it was for diplomats from different countries working for the United Nations in New York to comply with parking rules. These diplomats have immunity and therefore cannot be fined when they park illegally (they can be issued tickets, but they do not have an obligation to pay them). Their study shows that diplomats from corrupt countries are more likely to park illegally and, whenever fined, these same diplomats are less likely to pay these fines than diplomats from less corrupt countries. The lesson, as Fisman and Miguel put it, is 'that reformers of government institutions – whether local officials or World Bank hotshots – must be aware that values and social norms can undermine their attempts at change. In other words, altering the law is unlikely to be sufficient in the presence of a pervasive culture of corruption'.[84]

Corruption is more commonly explained as rampant in developing countries 'not because their people are different from people elsewhere, but because conditions are ripe for it'.[85] Institutional arrangements create opportunities and incentives for corruption, making the problem more pervasive in these nations. As Gray and Kaufmann explain:

> The motivation to earn income is extremely strong, exacerbated by poverty and by low and declining civil service salaries. (. . .) Not only motivation is strong, but also opportunities to engage in corruption are numerous. Monopoly rents can be very large in highly regulated economies, (. . .) The discretion of many public officials is also broad in developing and transition countries, and this systemic weakness is exacerbated by poorly defined, ever-changing, and poorly disseminated rules and regulations.[86]

Institutional arrangements that are often perceived to be conducive to corruption are size of the government and the degree of state intervention in the economy.[87] There are, of course, exceptions: large governments in Scandinavian countries are associated with some of the lowest levels of corruption in the world. But there seems to be a clear pattern otherwise. It is possible that this is simply because the larger the role of the government, the more opportunities will be available for abuse of that power.[88] Corruption is also encouraged where economic activity is highly regulated by the government (less true of governments in Scandinavian countries who place greater emphasis on social programs), as substantial rents will accrue to organizations that are able to attract the favour of government decision makers.[89] This is exacerbated in closed economies where international competition for markets is limited.[90] Natural resource rents may also encourage corruption,[91] as may the presence of highly corrupt neighbouring countries.[92]

Poor government quality can be either a cause or a consequence of corruption. Sometimes they reinforce each other and the causal arrow runs in both directions. There are, however, certain institutional arrangements that are more often correlated with higher levels of corruption, as Lambsdorff shows in a detailed review of the literature.[93] Centralized states seem to be more corrupt than federal states with a high level of fiscal decentralization. This seems especially true if decentralization reforms take place in countries that have civic cooperation, trust among people, and well-developed sub-national units. The relationship between democracy and corruption is non-linear: democratic practices inhibit corruption after a country has a robust, fully functional democratic regime; however, corruption in medium-democratic regimes is higher than in totally authoritarian countries. Within democracies, smaller voting districts, proportional representation and presidential systems are correlated with higher levels of corruption. After reviewing the studies that support these findings, Lambsdorff summarizes the lessons for reformers, as follows:

> In sum, democracy reduces corruption, but not the lukewarm type, not the type with little electoral participation and not immediately after its implementation. Before transforming authoritarian systems into halfhearted democracies it is worthwhile considering whether such systems have established their peculiar methods of honoring integrity and how these might be endangered during

---

[83] Raymond Fisman and Edward Miguel, 'Corruption, norms and legal enforcement: evidence from diplomatic parking tickets' (2007) 115 *Journal of Political Economy*.

[84] Raymond Fisman and Edward Miguel, *Economic Gangsters: Corruption, Violence, and the Poverty of Nations* (Princeton, NJ: Princeton University Press, 2008) at 102.

[85] Gray and Kaufmann, *supra* note 42.

[86] Ibid., at 9.

[87] Lambsdorff, *supra* note 78.

[88] Ibid., at 14.

[89] D.R. Henderson, 'Power corrupts – editorial comment', *Wall Street Journal*, 19 April 1999.

[90] J. Sachs and A. Warner, 'Economic reform and the process of global integration' (1995) 25:1 *Brookings Papers on Economic Activity* 1–118.

[91] A. Ades and R. Di Tella, 'Rents, competition, and corruption'(1999) 89 *American Economic Review* 982–94.

[92] W. Sandholtz and M. Gray, 'International integration and national corruption' (2003) 57:4 *International Organization* 761–800.

[93] Lambsdorff, *supra* note 78.

> transition. Thinking about an ideal type of democracy, there is evidence that presidential systems fare worse with respect to corruption as compared to parliamentarism. But it remains to be seen whether presidentialism might be a second best option where political parties are of poor quality. Finally, but less strong in magnitude, electoral systems of proportional representation are associated with higher corruption than plurality rule with single-member districts. Westminster democracy would be the model best capable of reducing corruption.[94]

It is not very often, however, that reformers find themselves in a position to change a country's political regime. The windows of opportunity for state-building exercises are rare and more often than not reformers will be able to do little to change the political institutions along the lines suggested by Lambsdorff. With this in mind, we turn to potential reform options that take into account the fact that the reformers are not writing on a blank slate.

E. Potential Cures

Institutional reforms can reduce the opportunities and incentives to use public office for private gains and therefore have significant potential to reduce overall levels of corruption. In this regard, Susan Rose-Ackerman provides the following categories of reform strategies that are available for tackling corruption:

(a) the redesign of government programs to limit the underlying incentives for corruption by limiting the pay-offs available from corruption;
(b) increasing accountability and transparency of government actions to increase the likelihood of preventing corruption;
(c) more radical reforms of government structure, such as constitutional re-engineering, to limit opportunities for corruption.[95]

In addition to these strategies, a common proposal is the creation of anti-corruption watchdog bodies, such as the Hong Kong Independent Committee against Corruption (ICAC), which was created in 1974 in response to perceived high levels of corruption in Hong Kong society.[96]

---

94 Ibid.
95 Rose-Ackerman, *supra* note 41.
96 Daniel Kaufman, 'Revisiting anti-corruption strategies: tilt towards incentive driven approaches?' in *Corruption and Integrity Improvement Initiatives in Developing Countries* (New York: UNDP, 1998).

This body conducts high-profile investigations and prosecutions which have led to a significant decrease in corruption levels since its creation.[97] The results have been particularly striking in the Hong Kong Police Department, where the ICAC, operating completely separately from regular law enforcement bodies, was able to launch a strong anti-corruption offensive, including the investigation, arrest and interrogation of police management and officers. The success of these efforts was largely as a result of maintaining routine investigations, regardless of the presence of specific reports of corruption.[98]

As well as focusing on enforcement and prevention, the ICAC also included mass public education campaigns, which informed citizens about the role of the ICAC, and the illegality of corruption and what this comprised. Reporting of corruption was also encouraged, and this served to increase social disapproval of corrupt activities. This fundamental change in the attitudes of the Hong Kong community was coupled with the institutional changes necessary to increase public perceptions of corruption control, especially within the police.[99] The results of these efforts was the eradication of syndicated police corruption by the end of the 1970s, and a clear reduction in corruption in government by the late 1980s.[100] This created 'a new equilibrium of clean government', and the public expectation that this should remain the norm.[101]

It is important to acknowledge, however, that the creation of an anti-corruption body alone is unlikely to be an effective measure to tackle corruption. As in other cases of reform, there are important institutional interconnections that require more than stand-alone reforms. For instance, there is little that a watchdog can do without strong anti-bribery legislation and an effective independent court system to enforce the applicable sanctions. There is also a more indirect connection between reform success and incentives and opportunities for corruption. Some reforms may increase the risk of punishment, but they are less likely to be effective if strong incentives and opportunities for corruption remain. Indeed, a great deal of the Hong Kong experience is also based on a variety of specific institutional reforms including, for instance, the legalization of

---

97 Bertrand de Speville, *Hong Kong: Policy Initiatives against Corruption*, (OECD Development Centre Publishing, 1997).
98 Melanie Manion, *Corruption by Design: Building Clean Government in Mainland China and Hong Kong* (Cambridge, MA: Harvard University Press, 2004) at 41.
99 Ibid., at 44.
100 Ibid., at 72.
101 Ibid.

off-track betting, which eliminated an opportunity for police officers to extract bribes from citizens.[102]

Another challenge for institutional reforms is that they need to account for self-reinforcing mechanisms in corruption practices. As Bardhan explains,[103] adopting a game theoretic approach, social norms can settle in multiple equilibria, making the problems of corruption relatively rare, widespread or systemic. The basic assumption is that expected gains from corruption depend on the number of other people who are expected to be corrupt. In this context, there are three possible equilibria: (i) nobody is corrupt, and it does not pay to be corrupt; (ii) everyone is corrupt, and it does not pay to be non-corrupt; (iii) there are both corrupt and non-corrupt officials, who are indifferent between being corrupt or non-corrupt. While the first and the second equilibria are stable, the third is not: if more and more officials decide to be corrupt, this can tip the equilibrium to one where everyone is corrupt.[104] Self-reinforcing mechanisms will be an obstacle for institutional reform in cases in which there is an equilibrium where everyone is corrupt and these social norms are very stable. In cases 'where there is systemic corruption, the institution's rules and norms of behavior have already been adapted to a corrupt modus operandi, with bureaucrats and other agents often following the predatory examples of, or even taking instructions from, their principals in the political arena'.[105]

On the other hand, small changes in an unstable equilibrium can tip the balance in the opposite direction, towards the point where nobody is corrupt. In this regard, reformers can use self-reinforcing mechanisms to move the equilibrium towards lower levels of corruption. For instance, the functions of an anti-corruption watchdog can be reinforced by the creation of various kinds of accountability mechanisms, such as 'an independent office of public auditing, an election commission to limit and enforce rules on campaign contributions in democratic elections, (. . .) an office of local ombudsman with some control over the bureaucracy, citizens' watchdog committees providing information and monitoring services and pursuing public-interest litigation'.[106]

In addition to institutional interconnections and self-reinforcing mechanisms, there is yet another similarity between reforms to tackle corruption and other pro-development institutional reforms: the problem of an

[102] Robert Klitgaard, *Controlling Corruption* (University of California Press, 1988) at 116.
[103] Bardhan, *supra* note 42 at 152.
[104] Ibid., at 154.
[105] Gray and Kaufmann, *supra* note 42 at 8.
[106] Bardhan, *supra* note 42 at 162.

uncongenial political economy in which interest groups that benefit from corruption are likely to resist reform.[107] Systemic corruption means that many powerful groups are likely to fall in this category, making it difficult to identify the possible beneficiaries from reform who might be mobilized to promote the necessary changes. In these cases, for example, it might be necessary to wait for a window of opportunity where a dramatic change in political regime or a major public scandal makes it politically feasible to promote reform.[108]

In the case of bribery, one possible solution is to promote reform focused on multinational companies based in developed countries, but which operate within developing countries, often engaging with corrupt governments. Bribes involve two parties: the public official demanding the bribe (the demand side) and the private party willing to pay for it (the supply side). Thus, in addition to reforms that reduce opportunities and incentives for corruption among public officials, it is also possible to reduce opportunities and incentives for corruption among multinational corporations, thus reducing the supply side. These companies can be controlled by extraterritorial legislation in their countries of origin, which would also govern their acts outside the home country's territory. This would overcome some of the institutional complexities of promoting reform in developing countries.

One of the first countries to enact legislation against these practices was the United States. The 1977 Foreign Corrupt Practices Act (FCPA) forbids American companies from bribing foreign officials, or from knowingly arranging for a bribe through an intermediary.[109] However, there are limitations on its scope: the Act does not forbid payments to speed up bureaucratic processes (facilitation or 'grease payments') and in 1988 the Act was amended to expand the list of what qualifies as facilitation. This list now includes 'all payments to foreign officials to expedite procedures, such as customs procedures or permits, that would otherwise occur without a bribe, but more slowly'.[110] The Act applies to all US nationals, or entities established under US law or operating principally in the United States. Since the enactment of the FCPA, the United States has put considerable pressure on other countries to follow its actions.

[107] See Chapter 1, section IV, E. Why are Some Countries Afflicted with Persistently Bad Institutions?
[108] William Dillinger and Marianne Fay, 'From centralized to decentralized governance' (1999) 36 *Finance & Development* 4.
[109] Foreign Corrupt Practices Act, 15 U.S.C.78 m, 78dd-2, 78dd-3, 78ff.
[110] Alvaro Cuervo-Cazurra, 'The effectiveness of laws against bribery abroad' (2008) 39:4 *Journal of International Business Studies* 636.

In 1997, the OECD promulgated the first multilateral convention to combat bribery of foreign officials – the OECD Anti-Bribery Convention – which was also signed by Argentina, Brazil, Bulgaria, Chile and the Slovak Republic.[111] This document is fundamentally consistent with the basic principles of the anti-bribery provisions of the FCPA.[112] The Convention also includes the provisions of the 1995 Recommendation on the Tax Deductibility of Bribes of Foreign Public Officials, which recommended that member countries make bribes paid to foreign officials no longer tax deductible as a business expense, which has since been implemented by all signatories.[113] Although the implementation of the Convention has been heralded as significant progress in advancing anti-corruption efforts, its efficacy is limited by the allocation of minimal resources in many countries to monitoring compliance and enforcement, and often limited incentives to undertake such actions against a state's own businesses competing with foreign businesses for contracts in other countries. Also, major foreign investors such as China are not signatories; this creates collective action problems. Thus it may be a weak substitute for domestic institutional reform.[114]

A major source of the supply of bribes comes from multinational companies (MNCs) in natural resource extraction sectors. The result is often that 'bribery, cheating and imbalanced negotiating all cut into what rightfully ought to go to the developing country', as the MNCs are able to gain control of the desired resource without paying the country the full value which it would have received in a fair and competitive market.[115] Greater transparency in oil, gas and mining contracts would greatly increase the opportunities for developing countries to receive full value for their natural resources. The Extractive Industries Transparency Initiative is

[111] OECD Convention, OECD Doc. DAFFE/IME/BR(97)20, reprinted in 37 I.L.M. 1 (1998).

[112] Stuart H. Deming, *Foreign Corrupt Practices Act and the New International Norms* (American Bar Association, 2010, 2nd edn).

[113] OECD Convention, OECD/C(96)27/Final, (1996), reprinted in 35 I.L.M. 1311 (1996).

[114] Ben W. Heineman, Jr. and Fritz Heimann, 'The long war against corruption,' (May/June 2006) *Foreign Affairs*; Kevin Davis, 'Self-interest and altruism in the deterrence of transnational bribery' (2002) 4:2 *American Law and Economics Review* 314–40; Kevin Davis, 'Does the globalization of anti-corruption law help developing countries?' in Julio Faundez and Celin Tan (eds), *International Economic Law: Globalization and Developing Countries* (Cheltenham, UK: Edward Elgar, 2010).

[115] Joseph Stiglitz, *Making Globalization Work* (New York: W.W. Norton & Co., 2006) at 140–41.

a recent initiative involving a coalition of governments, companies, civil society groups, investors and international organizations that 'supports improved governance in resource-rich countries through the verification and full publication of company payments and government revenues from oil, gas and mining'.[116] Governments and companies that sign the Initiative do so voluntarily, and are then bound to publish all payments made, or payments received, which are independently verified by a multi-stakeholder group. How effective such a voluntary initiative is likely to prove remains to be tested by experience.

VI. CONCLUSION

It seems clear that there is not a single bureaucratic regime that represents an ideal for all countries, at least at an operational or organizational level, notwithstanding the importance of Weberian characteristics as general benchmarks. The same can be said for anti-corruption reforms. As Fukuyama has pointed out, even amongst developed countries with well-performing bureaucracies, operational and organizational details vary vastly and are the legacy of the particularities of history, culture, politics and economic imperatives, and are not readily transplantable to or adaptable by other countries.[117] Civil service reform initiatives need to take the legacies of the past seriously if they are to be both feasible and predictable in their effects in the context in question.[118] Hence, as with the design of legal and political institutions, a premium attaches to adaptive and incremental strategies in advancing the agenda for bureaucratic and anti-corruption reform. These initiatives cannot effectively be imposed by 'outsiders' but require domestic leadership and mobilized local political constituencies to promote and support them. Lessons from comparative experience and external financial and technical resources may usefully complement such initiatives but cannot substitute for them. As with the conclusion reached in other chapters, lawyers have an important role to play in this complex exercise of designing institutional solutions that meet the needs and address the particular challenges of each country.

[116] Extractive Industries Transparency Initiative, 'What is the EITI?' Available at http://www.eitransparency.org/eiti.

[117] Frances Fukuyama, *State-Building, Governance and World Order in the 21st Century* (Ithaca, NY: Cornell University Press, 2004).

[118] Kohli, *supra* note 36.

6. State-owned enterprises, privatization and development[1]

I. INTRODUCTION

In the 1980s and 1990s a wave of privatizations swept the world. State-owned enterprises (SOEs) in many countries were sold to private investors in sectors as varied as steel, mining, banking, telecommunications, electricity and water. From 1977 to 1999 there were 2459 privatization deals in 121 countries.[2] Privatization, together with a number of other reforms that constituted the so-called 'Washington Consensus',[3] was part of an internationally accepted strategy for fostering economic growth. Before these privatizations, governments (especially those in developing countries) assumed many of the economic functions pursued by the private sector in other countries, as exemplified by the prominent role played by SOEs in delivering infrastructure services in some developed and most developing countries. Privatization reforms were driven by the assumption that these functions could be more efficiently performed by the private sector. However, in many cases, privatization fell short of delivering the expected results. These outcomes, combined with the pitfalls of other 'Washington Consensus' policies, have forced reformers and academics to revisit many of their original assumptions and adopt a more cautious perspective on privatization. In some cases, privatization may be a solution, but in others it is not. And even in those cases where it may be a solution to the inefficiencies of the public sector, it is not the only one. Many alternatives to privatization can and should be considered in implementing reforms.

[1] Portions of this chapter are adapted and updated from two previous publications by one of the authors: D. Andrew, C. Smith and Michael J. Trebilcock, 'State-owned enterprises in less developed countries: privatization and alternative reform strategies' (2001) 12 *European Journal of Law and Economics* 240; and Ronald J. Daniels and Michael J. Trebilcock, 'The private provision of public infrastructure: an organizational analysis of the next frontier' (1996) 46 *University of Toronto Law Journal* 393.

[2] Bernardo Bortolotti, Marcella Fantini and Domenico Siniscalco, 'Privatization around the world: evidence from panel data' (2003) 88 *Journal of Public Economics* 305.

[3] See Chapter 1.

The discourse about privatization may have changed, but the challenge remains the same. On one hand, state-owned companies may provide social and political benefits to a country, but this may come at significant economic and fiscal costs because of operational inefficiencies. On the other hand, private companies may be able to deliver essential and basic services, such as electricity or telecommunications, but there are significant challenges in ensuring that these companies will provide universal service, and foster other social and political goals. Reducing the inefficiencies of state-owned companies can provide infrastructure for other economic activities, thus fostering economic growth. However, this goal cannot be decoupled from alleviating poverty and providing universal access to essential services. This is especially true in developing countries. As a consequence, alternatives to privatization are still prominent on the development agenda.

This chapter analyses the arguments for and against privatization of state-owned companies, reviews the evidence from the most recent privatization experiences around the world, discusses possible reasons for the failures and assesses the possible alternatives. The conclusion is that there are at least two strong institutional components in privatization processes. The success or failure of privatization is connected both with a country's broader institutional environment (a healthy private sector, effective regulation, lack of corruption, a stable political system) and with the institutional details of the specific privatization strategy adopted by reformers. The same is true for alternatives to privatization, such as public–private partnerships for the development of new infrastructure. Thus, reforms to improve the delivery of basic services in developing countries are intrinsically connected to the reforms discussed in other chapters of this book.

II. STATE-OWNED ENTERPRISES AND DEVELOPMENT

A. Rationales for State-Owned Enterprises

State-owned enterprises emerged in the developing world for a mix of political, ideological and economic reasons. They were often formed (and subsequently expanded) to marshall support for new and fragile governments in developing countries: the larger an SOE sector, the larger a government's direct influence over its economy. Developing country

governments were also influenced by the spread of socialist ideology following World War II, which dictated that the state should control the 'commanding heights' of its economy.[4] Nationalism, often in the form of sovereignty concerns following decolonization, similarly fuelled the desire for developing countries to control the strategic sectors of their economies. SOEs were also advocated as a workable method of income redistribution – for example, by reducing prices of goods primarily consumed by the poor – especially in developing countries with large informal sectors in which income redistribution could not practically be accomplished through a progressive tax system. Profitability often was not the most important goal behind their creation.

The primary economic motivation behind SOEs was increased capital investment. Several constraints hindered capital investment in developing countries in the years following World War II, the most important of which was low domestic savings rates. Developing countries also often lacked the institutions, such as effective financial intermediaries, necessary to facilitate allocative efficiency in capital markets. Moreover, developing countries suffered from market failures, such as low-level investment traps and a lack of basic infrastructure. In addition to ostensibly addressing these problems, SOEs also served other economic purposes, including combating inflation, controlling industries susceptible to natural monopolies, protecting fragile developing country economies from external shocks, and promoting regional development within a developing country. Thus, SOEs were not created exclusively to generate revenue for the nation state but were also intended to yield economic and social benefits above and beyond any financial reforms.[5] When assessing the success of SOEs,

[4] See, e.g., Mehdi Haririan, *State-Owned Enterprises in a Mixed Economy: Micro versus Macro Economic Objectives* (London: Westview Press, 1989) at 10; Russell Muir and Joseph P. Saba, *Improving State Enterprise Performance: The Role of Internal and External Incentives* (Washington, DC: World Bank, 1995) at 11; R.C. Dutt, *State Enterprises in a Developing Country: The Indian Experience 1950–90* (New Delhi: Abhinav Publications, 1990) at 4; Dieter Bös, *Public Enterprise Economics* (Amsterdam: North-Holland, 1986) at 26; Thomas J. Trebat, *Brazil's State-Owned Enterprises: A Case Study of the State as Entrepreneur* (New York: Cambridge University Press, 1983) at 65; Malcolm Gillis, 'The role of state enterprises in economic development' (1980) 47: 2 *Social Research* 248 at 263.

[5] For some less developed countries (LDCs), SOEs operated as an institutional bypass, as these countries suffered from a lack of bureaucratic capacity, more specifically an inability to tax and regulate private enterprise at arm's length, and state ownership offered an alternative means of taxation: World Bank, *World Development Report 1991: The Challenge of Development* (New York: Oxford University Press, 1991) at 130.

particularly in comparison to private enterprises, it is important to evaluate an SOE in the light of its putative social purposes.

B. The Cost of Poor SOE Performance

Between 1986 and 1991, an increasing number of SOEs in developing countries were unable to generate the resources needed to finance their operations, expansion and the servicing of their debts.[6] While it may be efficient to invest with borrowed money where an investment is expected to generate positive gains in the future, it is inefficient to finance low productivity investments with borrowed money, which has been the case with many developing country SOEs.

The persistent deficits of SOEs trigger derivative social costs. First, SOEs receive a disproportionate amount of domestic investment, significantly increasing the cost of capital of private enterprises in developing countries. More generally, inefficient levels of production in SOEs result in the withdrawal of resources from areas of the economy in which they might be more productively employed. An SOE sector typically represents about 11 per cent of GDP in developing economies, rising to an average of 14 per cent in the poorest developing countries. The SOE share of gross domestic investment (GDI) is generally much higher: in 1991 accounting for about 18 per cent of GDI in developing economies and about 27 per cent in low-income countries.[7] By way of contrast, SOE sectors typically represented about 8 per cent and 13 per cent of GDI respectively in high-income economies in 1988, and is now much lower as a result of privatizations.[8] Second, developing country governments, which are often reluctant to cut social expenditures, tend to cut expenditures with long-term benefits (such as infrastructure) in order to finance SOE deficits.[9] The direct and indirect losses attributable to poor SOE performance have been estimated at between 5 and 8 per cent of GDP in the typical developing

[6] In this period, the savings-investment (S-I) deficit averaged 1.7 per cent of GDP in the typical low-income economy and 0.8 per cent of GDP in developing countries generally: Mary M. Shirley et al., *Bureaucrats in Business: The Economics and Politics of Government Ownership* (Washington, DC: World Bank, 1995) at 42–3. Available at http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/1995/09/01/000009265_3961219104659/Rendered/PDF/multi0page.pdf

[7] Ibid., at 34.

[8] Ibid., at 33.

[9] For example, average capital expenditures in sub-Saharan Africa fell from 8.7 to 6.1 per cent of GDP during the 1980s: World Bank, *Private Sector Development in Low-Income Countries* (Washington, DC: World Bank, 1995) at 50.

Further, unlike private sector shareholders, citizens, even as voters, have very little control over the composition of the state's executive. Government ministers are not held liable for the corporate failings of the organizations they monitor in the same way as corporate directors. A final important factor is that, unlike private corporations, SOEs often face multiple economic and non-economic objectives.[19] This makes it difficult for SOE monitors to properly assess the performance of managers, who can blame poor enterprise financial performance on non-commercial objectives. This is not to say that such control is impossible, but well-managed SOEs tend to be the exception, rather than the rule. In sum, private enterprise often offers better management incentives, better monitoring incentives and better monitoring capabilities than government ownership.

D. The Competition Effect

Another possible explanation for the inefficiencies of SOEs is the fact that, in the absence of natural monopoly, private enterprise encourages competition whereas government ownership tends to encourage monopoly. Competition engenders allocative efficiency by removing the ability to set prices from the monopolist and placing it in the market. In theory, where producers in a competitive market are earning economic profits, other producers will enter the market and supply consumers with the same goods until the price of the product has been driven down to the marginal cost of production. In this way, consumers' demands are brought in line with the marginal costs of supply and the deadweight loss associated with monopoly production is eliminated.

In theory, competition also engenders productive efficiency by encouraging producers to minimize costs. Where cost reductions permit producers to earn economic profits, new producers will enter the market, once again driving prices down to the marginal cost of supply. In these circumstances, constant attention to productive efficiency becomes a matter of an organization's very survival. In contrast, monopolists are not faced with the threat of being priced out of the market place, and so do not have the

1992) *National Westminster Bank Quarterly Review* 2 at 20; Michael J. Trebilcock and J. Robert S. Prichard, 'Crown Corporation: the calculus of instrument choice', in J. Robert S. Prichard (ed.), *Crown Corporation in Canada: The Calculus of Instruments Choice* (Toronto: Butterworths, 1983) at 34.

19 In fact, a manager will often face as many sets of multiple objectives as government officials/bodies having control over his or her SOE (e.g., senior bureaucrats, ministers of state, the head of state, etc.), Jones, 'Performance evaluation for state-owned enterprises', *supra* note 11 at 181.

same incentives to increase productive efficiency. An additional benefit of competition is that it provides clear information on relative management performance to corporate monitors. Competition also tends to increase dynamic efficiency (innovation) over time more than monopolistic market structures.

III. PRIVATIZATION

The term 'privatization' is often used ubiquitously to cover a wide range of different policy options. However, generally speaking, it refers to the transfer of productive assets from the state sector to the private sector.[20] Depending on the way it is implemented, privatization may be one, but not the only, solution to the sizable social costs inflicted by poor SOE performance.

A. Historical Context

While there were isolated cases prior to the 1980s,[21] privatization as a broad-based economic policy did not truly come of age until its implementation under the UK Thatcher administration during the 1980s when, between 1979 and 1997, the Conservative government reduced the SOEs' share of GDP from approximately 10 per cent to nearly nothing.[22] It was not until the 1990s, however, that privatization programs outside the United Kingdom truly began to accelerate. As a result, privatization represented a major policy change in the economies of the world: from 1980 through 1999, governments throughout the world generated over US$1 trillion in revenue from privatization.[23]

With respect to developing countries, divestitures in the first part of the 1980s involved relatively small SOEs, primarily in commerce, services,

20 David Parker and Colin Kirkpatrick, 'Privatisation in developing countries: a review of the evidence and the policy lessons' (2005) 41 *Journal of Development Studies* 4 at 514.

21 For example, the German Christian Democrat governments of the 1950s and 1960s: William Megginson, Robert Nash and Matthias van Randenborgh, 'The financial and operating performance of newly privatized firms: an international empirical analysis' (1994) 49 *Journal of Finance* 403 at 406; and the Pinochet government of Chile following the overthrow of President Allende.

22 William L. Megginson and Jeffrey M. Netter, 'From state to market: a survey of empirical studies on privatization' (2001) 39:2 *Journal of Economic Literature* 321 at 324.

23 Ibid., at 326.

light manufacturing and agribusiness.[24] Subsequently, they have also included the sale of large SOEs in major infrastructure sectors, such as utilities and transportation.[25] At the beginning of the privatization movement, there were wide regional variations in government divestiture in developing countries: Latin America accounted for 55.1 per cent of the value of all divestitures occurring in the developing world between 1988 and 1993, while in the same period divestitures in Asia and Africa, respectively, accounted for just 19.7 and 3.2 per cent of the value of total divestitures of developing countries.[26] The landscape, however, has since changed. According to the World Bank, Latin America's share of the global total value of privatization fell from nearly 60 per cent in the 1990s to 3 per cent in 2006. East Asia now leads the developing world in privatization value, raising US$74 billion in 2007 – an increase of 45 per cent from 2006 and a staggering 236 per cent from 2004–05,[27] which is primarily attributable to initial public offerings (IPOs) in China.

B. Theory versus Practice

The theory behind SOEs holds that the ownership and competition effects undermine the performance of SOEs. However, it is important to examine the empirical evidence to test whether these theoretical conjectures are borne out in practice, first by comparing the relative performance of SOEs and private organizations in the same sectors, and then comparing pre- and post-privatization performance. It is important to note that evaluating the impact of privatization on organizational performance is extremely difficult in transition or developing economies partly because of the challenges in obtaining accurate information. A greater problem, however, is that it is difficult to isolate the impact of one variable, privatization, when a society may be undergoing numerous economic, political and social changes, all of which can impact on organizational performance and lead to erroneous or misleading conclusions.

24 Shirley et al., *supra* note 6 at 27; Christopher Adam, William Cavendish and Percy S. Mistry, *Adjusting Privatization: Case Studies from Developing Countries* (London: James Currey, 1992) at 39–40.

25 Shirley et al., *supra* note 6 at 27.

26 *Ibid* at 28.

27 Sunita Kikeri and Verena Phipps, 'Privatization trends: a record year for initial public offerings in 2007', in World Bank Group, Financial and Private Sector Vice Presidency, October 2008, Note 321.

1. Relative sectoral performance

According to Parker and Kirkpatrick, most sectoral studies involving developing countries have focused on reform in utilities, particularly telecommunications.[28] This is due to two factors: first, telecommunications have been particularly affected by privatization[29] and, secondly, data is readily available from annual reports published by the International Telecommunications Union (ITU) in Geneva. While there are some differences between the specific conclusions of the numerous studies,[30] researchers have mostly found that privatization impacted positively on the telecommunications industry in terms of teledensity levels (service coverage),[31] decreases in service costs[32] and profitability.[33] Perhaps more

28 There have been studies conducted in other utilities sectors, such as energy and water and sewage. In terms of energy, Zhang, Parker and Kirkpatrick conducted two studies modelling the impact of privatizing electricity generation in developing countries, looking at 51 economies between 1985 and 2000/01. They found that, while competition increased service penetration, capacity expansion and labour productivity, the effect of privatization alone was statistically insignificant except for capacity utilization. They also found that sequencing the reforms was vital to achieving improvements. Case studies conducted by Gray in 2001 and Estache, Gomez-Lobo and Leipziger in 2000 both found that electricity privatization resulted in fewer blackouts, higher labour productivity and lower electricity costs. However, other studies such as those by Sravat in 1998 yielded more equivocal results, finding that privatization of energy can result in disputes that are very costly. Studies of the water and sewerage sector, which was privatized largely by concessions, have been generally positive with respect to the impact of privatization. Concessions have led to improved services, higher productivity, reduction in tariffs and new connections. For details see Parker and Kirkpatrick, *supra* note 20 at 519.

29 According to Li et al., in 1980, approximately 2 per cent of telecommunications firms were privatized but that number rose to 42 per cent by 1998. See Parker and Kirkpatrick, ibid.

30 For a detailed and comparative explanation of the findings and methodological differences and shortcomings of the various studies, see Parker and Kirkpatrick, ibid.

31 See D. Petrazzini and T.H. Clark, 'Costs and benefits of telecommunications liberalization in developing countries' (1996) Working Paper, Hong Kong: Hong Kong University of Science and Technology; A.J. Ros, 'Does ownership or competition matter? The effects of telecommunications reform on network expansion and efficiency' (1999) 15 *Journal of Regulatory Economics* at 65.

32 See S.J. Wallsten, 'An econometric analysis of telecom competition, privatization and regulation in Africa and Latin America' (2001) 43 *Journal of Industrial Economics* 1 at 1.

33 B. Bortolotti, J. D'Souza, M. Fantini and W.L. Megginson, 'Privatization and the sources of performance improvement in the global telecommunications industry' (2002) 26 *Telecommunications Policy* at 243.

also industry-specific. As we suggest below, both economic and political factors are institutional in nature.

1. Economic prerequisites

The four primary and interconnected economic prerequisites are: (i) a healthy private sector; (ii) effective regulatory structures; (iii) macroeconomic stability; and (iv) an absence of corruption.

First, privatizing SOEs into a non-competitive environment may result in economic losses, including deadweight losses associated with monopoly pricing and possibly the further crowding out of the indigenous private sector as private monopolists exploit their economic power. One solution to the absence of a competitive private sector, especially in the case of natural monopolies, is regulation. The absence of effective regulation has been a major cause of mediocre post-privatization performance in lower-income developing countries.[38] While designing an effective regulatory regime is an extremely complex exercise that is dependent on context, it is important that these regulatory arrangements should be finalized prior to divestiture. Changes in the regulatory structure following privatization undermine the government's credibility with potential investors, and thus impact negatively on levels of investment.

With respect to macroeconomic instability, the dangers of privatizing in a crisis are obvious. Macroeconomic instability increases economic uncertainty and therefore investment risk, and thus results in decreased interest by domestic and foreign investors in the SOEs of a developing country. Perversely, developing country governments often face increased incentives to privatize in times of economic crisis as a result of a dire need for revenue. With severely constrained bargaining power, such developing countries may be forced to accept terms that are far less attractive than they could have achieved in the absence of a crisis. Moreover, in order to maximize revenue from privatization, developing countries may be tempted to turn public monopolies into private monopolies. Decisions to privatize should be made on the basis of an analysis of the long-term social benefits of a given divestiture, not the state's need for immediate revenue.

The final economic prerequisite is the absence of corruption. Prima facie, one might think that corruption in the public sector would make privatization desirable. However, privatizing SOEs in developing countries with highly corrupt public sectors can greatly increase the costs of such corruption. These include the more obvious costs such as kickbacks in the privatization process, but also involve problems such as officials making and implementing privatization decisions on the basis of personal or political gain rather than social benefit (which, arguably, militates in favour of a centralized, specialized agency with well-developed protocols for privatization), or the fact that widespread corruption undermines investor confidence. Moreover, corruption may not only impede original investment in SOEs, but may also impede subsequent investment in the divested enterprise, thereby destroying one of the key benefits promised by privatization: increased capital investment.

These prerequisites are institutional in nature because they depend on a complementary set of private and public sector institutions. For instance, a healthy private sector requires a functioning financial system, an appropriate regulatory framework depends on a functioning bureaucracy, and a stable macroeconomic environment depends on a functional and competent central bank (inter alia).

2. Political prerequisites

Even where a developing country has the institutions in place to make privatization welfare-increasing, privatization will only succeed if it is politically practicable. This involves two considerations: (i) whether key policy-makers in developing countries are desirous of implementing privatization; and (ii) if so, whether privatization can succeed in the face of political opposition.

Shirley, in a study examining the success of SOE reform in 12 developing countries, found that both political desirability and political feasibility were necessary elements of SOE reform.[39] According to Shirley, however, privatization will be politically desirable in only two circumstances: (i) where a developing country government has experienced a change in leadership and the new leader is not dependent on SOE interests for his or her support; and (ii) where privatization is demanded by an economic crisis.[40] Although, in Shirley's research, an economic shock alone was insufficient, Campos and Esfahani found – in studying SOE reform attempts in 15 LDCs over the period 1972 to 1991 – that 19 of the 24 reform attempts studied were preceded by a crisis (although this involves the serious dangers noted above).[41]

---

38 Boubraki, Narjess and Jean-Claude Cosset, 'The financial and operating performance of newly privatized firms: evidence from developing countries' (1998) 53 *Journal of Finance* 1081; Colin Kirkpatrick, David Parker and Yin-Fang Zhang 'An empirical analysis of state and private-sector provision of water services in Africa' (2006) 20:1 *World Bank Economic Review* 143.

39 Shirley et al., *supra* note 6 at 175–6.

40 Ibid., at 178–9

41 Jose Edgardo Campos and Hadi Salehi Esfahani, 'The political foundations

In terms of political feasibility, this often not only includes placating opposition parties, but also garnering the support of the workforce. Ultimately, however, political feasibility is affected by the credibility of the developing country government, especially where the government seeks to win the workers' support, for example, with the carrot of shares in the divested SOE. Unless a government's reform plans are credible, workers are unlikely to give up the rents they may be receiving from their public sector jobs for shares, which have some probability of being worthless. However, where workers are permitted to purchase underpriced shares in a divested enterprise, the government instantaneously creates a constituency that will oppose a reversal of the divestiture.[42]

D. Shock Therapy versus Gradualism

In determining how to shift from an economy dominated by SOEs, there are two primary schools of thought: the shock therapists and the gradualists. Shock therapy is based on the premise that both markets and market institutions will quickly and spontaneously appear with rapid economic liberalization. According to leading proponents, such as Anders Aslund,[43] shock therapy includes a broad range of policies aimed at reducing government involvement in the economy. Such measures include price and exchange rate liberalization (including the break-up of currency zones), privatization of SOEs, macroeconomic stabilization, and the removal of export and import subsidies and wage and price controls.

Rapid reform advocates consider a gradual approach to transition to be needlessly costly, both in terms of time and lost output. In part, this set of economic prescriptions has been predicated on a set of political assumptions – a kind of political Coase theorem of privatization: (i) the initial owners of privatized assets do not matter much as the market will soon reallocate the assets to efficient owners; and (ii) appropriate laws and legal institutions will follow private property rather than the other way around. This view assumes a critical interaction between economic

of public enterprise reform in developing countries' (World Bank, 1994, unpublished) at 23.

[42] Ibid., at 9.

[43] See, for example, Anders Aslund, 'Why has Russia's economic transformation been so arduous?' World Bank Annual Bank Conference on Development Economics, Washington, DC, 28–30 April 1999. See also, Jeffrey Sachs, 'The transition at mid-decade' (1996) 86 *American Economic Review* 128; Jeffrey Sachs, 'Reforms in Eastern Europe and the former Soviet Union in light of the East Asian experience' (1995) 9 *Journal of the Japanese and International Economies* 454.

and political reforms – namely that economic reforms create pressure for political reforms and that business pressures are likely to play a critical role in political and consequential legal reforms. The underlying presumption is that such pressures did not exist before the economic reforms.[44]

By contrast, gradualists such as Joseph Stiglitz and Kenneth Arrow caution that rapid liberalization will be impractical to implement because privatization requires a broad social consensus, and generating such consensus is a long-term process.[45] Gradualists tend to favour an extended period of state intervention: price and wage controls, fixed exchange rates, gradual privatization and nurturing of market institutions are key elements of this process. Gradualists also tend to emphasize the importance of the institutional infrastructure of a market economy, including competition, entrepreneurship, regulation of financial markets, social capital and a strong legal system.[46]

Both shock therapists and gradualists claim that the performance of transition countries proves the relative success of their reform agenda. Poland, Kyrgyzstan, the Czech Republic and the Baltic states, as radical liberalizers, have grown faster than 'go-slow' countries such as Belarus and Ukraine.[47] On the other hand, China has created its own path of gradual transition from a planned to a market economy, and has enjoyed enormous economic success. Russia's economic decline in the period following the break-up of the Soviet Union is cited by both sides to prove their point: gradualists argue that the Russian experience proves that shock therapy was seriously misconceived, while advocates of shock therapy reclassify Russia as a go-slow reformer because they believe reforms were partial at best.

IV. TYPES OF PRIVATIZATION

Several conclusions can be drawn from the above discussion of SOEs and privatization. First, SOEs in the developing world are often sources

[44] Andrei Shleifer and Robert Vishny, *The Grabbing Hand: Government Pathologies and Their Cures* (Cambridge, MA: Harvard University Press, 1998) Chapter 11.

[45] See, e.g., Joseph E. Stiglitz, 'The insider' (17 April 2000) *The New Republic*; Joseph E. Stiglitz, 'Whither reform? Ten years of the transition,' World Bank Annual Bank Conference on Development Economics, Washington, DC, 28–30 April 1999; Joseph E. Stiglitz, *Globalization and Its Discontents* (W.W. Norton & Co., 2002); Kenneth Arrow, 'Economic transition: speed and scope' (2000) 156 *Journal of Institutional and Theoretical Economics* 9.

[46] Stiglitz, 'Whither reform?' ibid.

[47] Schleifer and Vishny, *supra* note 44 at 228.

approaches. The first is *direct sale* whereby a SOE, or one of its component parts, is sold to an individual, a corporation or a group of investors. The second option is *share issue privatization* (also known as an SIP), where some or all of the government's holding in an SOE is sold through a public share offering. The sale of state property serves several concrete objectives, including producing revenue for the state, restructuring organizations and attracting foreign investors.[54]

This method of privatization can be controversial, however, as foreign investment represents a paradox to developing governments: while capital-starved developing countries are in need of foreign capital, foreign investment has often been perceived as a neo-colonialist threat to newly emergent states attempting to fashion their own societies rather than be absorbed into the political economy of the developed world. Thus, domestic investment may be more attractive to many developing economies, implying that a country's savings rate (savings as a percentage of GDP) will be a significant factor in the determination of the mode of divestiture adopted. This suggests that a developing country with a higher savings rate is likely not only to rely to a greater degree on domestic investment, but also to employ the public offering more frequently as a means of placing some portion of large SOEs in domestic rather than foreign hands.

Moreover, developing countries with higher savings rates are more likely to have the financial institutions necessary to facilitate a public offering. To date, direct sales to the domestic private sector in developing countries have been concentrated in smaller-scale activities associated with the commercial, manufacturing, service and agricultural sectors. The divestiture of larger enterprises, such as utilities, has relied more on foreign direct investment and public share issues.

D. Partial Privatization

Partial privatization of an SOE may be a desirable interim option for governments for whom full privatization is not politically desirable or feasible. Partial privatization may take the form of a partial public offering that, if the stock is widely traded, will introduce stock prices (and changes thereto) as a benchmark of an SOE's performance, as well as creating a private constituency with a direct stake in SOE efficiency. Alternatively, government could sell a minority interest to a single commercial partner or joint venture partner with needed capital and expertise and a role in the

[54] Brada, *supra* note 48.

SOE's governance, again with a direct stake in enhanced SOE performance. Under both options, full privatization may ultimately be rendered more politically feasible. Government credibility may, however, prove a serious problem with both of these options, in that the stakes of the minority investors are at risk of expropriation or devaluation by changes in policies by the controlling shareholder or government, being motivated by considerations other than efficiency. Hence, minority shareholders may be difficult to attract at all, or only at severely discounted acquisition prices, reflecting political risk.

V. ALTERNATIVES TO PRIVATIZATION

While there are many options in terms of how to privatize SOEs, there are also reform alternatives to privatization that should be identified. While developing countries work towards improving their institutions and strengthening their private sectors in preparation for divestiture, they can also improve their economies by implementing several public sector reforms. The following reforms, to a greater or lesser extent, seek to benefit from the ownership and/or competition effect.

A. Management Contracts

A management contract is an agreement between a government and a private party (often enforceable through international arbitration or governed by the law of a recognized centre of commerce) by which the private party agrees to operate the assets of an existing SOE for a fee, which will often be tied to performance. In other words, management contracts privatize SOE management without divesting the SOE's assets. Variations of the concept of management contracts for the development of new infrastructure are discussed more fully below (in section VI) in our discussion of public–private partnerships. Basic types of management contract in potentially competitive sectors are typical in only a handful of industries and in small numbers.

According to Shirley in a 1995 study, a worldwide search for management contracts revealed only 202 contracts, with 68 per cent of them concentrated in certain sectors: 46 contracts in agriculture (24 in sugar, 22 in Sri Lankan tea and rubber plantations), 44 in the hotel industry, 23 in infrastructure, 13 in food processing and beverages, and 12 in extractive sectors. Moreover, if one does not consider Sri Lanka (with 22 contracts in total), or the hotel industry contracts (which are spread all over the world), the remaining management contracts in the sample (136) were

despite some successes there have also been many failures. Obstacles to successful implementation of performance contracts include ensuring that SOE managers, who enjoy a significant information advantage over their government monitors, do not use this advantage to negotiate easily attainable performance targets, and ensuring that management remuneration is effectively tied to SOE performance. In one study,[61] only five of the twelve sample companies offered pecuniary bonuses as a performance award. This study also found a tendency for the governments of developing countries to breach their performance contract commitments with impunity, thereby seriously derogating from the significance attached to them by SOE managers.

Thus, the implementation of performance contracts does not appear to be a broad solution to the problem of SOE inefficiencies. Relative to privatization, performance contracts do not increase competition and they face serious obstacles in their attempt to induce good management. However, improvements can be made to the system, such as reducing bargaining inequality by channelling performance contracts through a centralized specialized agency, or using published and frequently updated benchmarks from comparable organizations in other sectors or countries to lower transaction costs. If these changes and assurances can be made to the performance contract systems in LDCs, SOEs that cannot (or should not) be privatized for economic or political reasons may still benefit from improved enterprise management.

C. Increased Competition

While management contracts and performance contracts attempt to improve SOE performance largely through improvements in management incentives and monitoring, these types of SOE reform have little impact on the level of competition faced by an SOE. There are four means by which governments of LDCs may introduce greater levels of competition in their SOE sectors: (i) the unbundling of monopolies; (ii) the reduction of import barriers; (iii) performance-based price regulation using competitive benchmarks from other jurisdictions; and (iv) competition laws.

As in the case of the other alternative reform options, they are still a less effective option than privatization, which takes advantage of the ownership effect as well as the competition effect. However, such a strategy

[61] Nichola Dyer Cissé, *The Impact of Performance Contracts on Public Enterprise Performance* (Washington, DC: World Bank, 1994), Background Paper, Policy Research Department, World Bank.

may be a preferable interim measure in situations where, for political or economic reasons, privatization is not a viable option. Like privatization, however, these strategies depend on the existence of strong institutions, including effective and competent competition and regulatory authorities. The challenges in building these institutions in developing countries, however, are not negligible.

VI. PRIVATE PROVISION OF PUBLIC INFRASTRUCTURE SERVICES: PUBLIC–PRIVATE PARTNERSHIPS

Having recognized the benefits of privatization and the circumstances that best engender the divestiture of SOEs, we also must acknowledge that there are some sectors that may not be well suited to privatization, notably public infrastructure. Public infrastructure, unlike other sectors, is often likely to be a natural monopoly in which competition is often neither feasible nor desirable. Moreover, infrastructure involves the creation or provision of basic and vital services such as water, electricity, communications and roads, where failures in service delivery or project completion can have a disastrous impact on consumers and users. Infrastructure is also a central component for the entire development enterprise, and therefore a form of public good. Poor physical infrastructure can undermine and impede other efforts towards economic growth and social progress while good infrastructure raises productivity and lowers production costs.[62] According to the World Bank, a 1 per cent increase in the stock of infrastructure is associated with a 1 per cent increase in GDP across all countries.[63]

However, maintaining and enhancing the quality of physical infrastructure requires massive capital infusions, which developing countries often lack in terms of their own resources. In 1994 the World Bank reported that inadequate maintenance was an almost universal (and costly) failure of infrastructure providers in developing countries. For example, it reported that timely road maintenance expenditures of US$12 billion would have saved road reconstruction costs of US$45 billion in Africa during the preceding decade. More recently, the OECD estimated that maintaining existing infrastructure and undertaking necessary extensions of its

[62] World Bank Development Report, *Infrastructure for Development* (Washington, DC: World Bank, 1994).
[63] Ibid.

coverage would entail costs of about 7 per cent of the GDP of developing countries, equivalent to about US$600 billion per year, while public spending on infrastructure in developing countries is presently around 3 per cent per year.

With this in mind, we consider alternative arrangements that maximize efficiency within infrastructure sectors, avoiding the endemic inefficiencies of SOEs and the risks associated with privatization, while attracting the capital investment necessary to finance the projects.

Generally speaking, the term 'public–private partnership' (PPP) refers to an arrangement that is aimed at harnessing private sector capital and expertise in designing, financing, building, managing and maintaining infrastructure projects through various mechanisms without entirely divesting the government of its ownership. In understanding PPPs it is useful to consider a continuum of service delivery arrangements. At one end is complete government provision of services (via SOEs and/or government departments) and at the other end is complete divestiture or privatization. PPPs are located somewhere in the middle, where the government retains some ownership or assets in a sector but divests other functions to private enterprises. More technically, the OECD defines a public–private partnership as

> an agreement between the government and one or more private partners (which may include the operators and the financers) according to which the private partners deliver the service in such a manner that the service delivery objectives of the government are aligned with the profit objectives of the private partners and where the effectiveness of the alignment depends on a sufficient transfer of risk to the private partners.[64]

In the absence of a significant transfer of risk, private service delivery can be viewed as a form of traditional public procurement.[65]

A. The Innovative Aspects of PPPs

Ronald Daniels and Michael Trebilcock argue that the most distinctive feature of many of the larger public–private sector infrastructure partnerships that have emerged in recent years is the integration within a single private sector organization or consortium of all or most of the functions of financing, designing, building, operating and maintaining the facility

[64] OECD, 'Public–private partnership: in pursuit of risk sharing and value for money' (2008) 17.

[65] Ibid., at 18.

in question.[66] Extensive integration is the main feature that brings about efficiency gains from PPPs in contrast with traditional government procurement, where the government specifies the quality and quantity of particular goods or services required and buys inputs from private sector organizations. However, the lack of effective integration of functions has often resulted in attenuated incentives to optimize the efficiency of the overall project.

A PPP's extensive integration of functions, on the other hand, allows the partners to coordinate and allocate resources more efficiently. The vertically integrated private-sector model might undertake various functions, such as project identification, design, financing, construction, operations and maintenance. With the extensive vertical integration of these functions in the provision of infrastructure, organizations may be able to coordinate these functions at lower costs than the government, yielding superior performance to more discrete forms of contracting out. The empirical evidence suggests that vertically integrated private providers of infrastructure services can complete initial infrastructure construction far more quickly than can be done under the traditional mode of public provision with discrete contracting out of particular functions. This is largely because of reductions in transaction and coordination costs and greater freedom from stringent government budget allocation and procurement regulations.[67]

An important offsetting feature of vertical integration may be a marked reduction in competition for infrastructure contracts. Very few organizations or consortia are likely to be able to assemble all the relevant specialized inputs required to bid on large integrated infrastructure projects.[68] Empirical evidence generally suggests that increasing the number of bidders from three to four can result in savings of up to 18 per cent; from seven to eight, up to 4 per cent; and from ten to eleven, up to 2 per cent.[69] A more competitive bidding process may be facilitated by less vertical integration.

[66] Daniels and Trebilcock, *supra* note 1.

[67] Issaka Ndekugri and Adrian Turner, 'Building procurement by design and build approach' (1994) *Journal of Construction and Engineering and Management* 120 at 250.

[68] David Sappington and Joseph Stiglitz, 'Privatization, information and incentives' (1987) 6 *Journal of Policy Analysis & Management* 572.

[69] R. Preston McAfee and John McMillan, *Incentives in Government Contracting* (Toronto: University of Toronto Press, 1988) at 151.

B. Types of Public–Private Partnership

Public–private partnerships in the development and operation of infrastructure that are proliferating throughout the world vary in both scale and nature. The OECD has categorized the various forms such arrangements may take:[70]

1. Service contracts: the least integrated form of PPP. The public sector retains overall operational responsibility and risks, while the private sector provides a bundle of services to a public utility. The two most common forms are:
   (a) *Management support*: the private partner provides the government with human and technical resources.
   (b) *Operation and management*: the private operator is responsible for the daily maintenance of the facilities following government performance criteria. In some cases the private operator may be in charge of operating the facilities.
2. Delegated management contracts: 'the public sector retains overall ownership of the assets, but delegates the responsibility for their operation to a private operator for a definite (often long) period of time'. The two most common forms are:
   (a) *Affermage or lease agreements*: the private operator manages, maintains and renews the facilities for a period of time. It is responsible for all existing assets but is not required to finance new facilities. The government is in charge of all new investment and ensuring compliance with existing laws.
   (b) *Concessions*: the private operator is entirely responsible for managing the services and all necessary investment for the length of the concession (for example, 20 years or more). Consumers are directly charged by the private operator, while the public authorities determine service terms and all key decisions related to charges.[71]
3. Construction support: the most integrated form, where the private operator participates in 'the design and construction phases of new infrastructure and carries at least some of the risks associated therewith'.

[70] This categorization is provided by the OECD report. Please see the full report for greater details: OECD, 'Encouraging public–private partnerships in the utilities sector: the role of development assistance', in NEPA/OECD Investment Initiative, *Investment for African Development: Making it Happen* (2005).
[71] OECD, ibid., at 6.

   (a) *Build Design Operate* (BDO): 'the private operator, for a fixed period of time, designs, constructs and operates new facilities, which remain the property of the public authorities. The private operator assumes the risks linked to design and management of the facility. It is paid a fee by the public authorities and commits to an overall cost for the facility's construction and operation'.
   (b) *Build Operate Transfer* (BOT): 'the private operator designs, finances and builds infrastructure. While formal ownership of the assets is assigned to the government, the private sector operates the project long enough to service any debt incurred and to earn a suitable return'.
   (c) *Build Own Operate* (BOO): 'the private investor retains ownership and control of the project. The public sector has no obligation to purchase the facility'.

Table 6.1 Characteristics of alternative forms of PPP

	Operation and maintenance	Ownership	Investment	Commercial risk	Duration (years)
Management support	Public and private	Public	Public	Public	1–2
O&M	Private	Public	Public	Public	3–5
Leasing	Private	Public	Public	Semi-private	8–15
Concession	Private	Public	Private	Private	20–30
BDO	Private	Public	Public	Private	20–30
BOT/BOO	Private	Public/private	Private	Private	20-30

Source: OECD, 'Encouraging public–private partnerships in the utilities sector: the role of development assistance', in NEPA/OECD Investment Initiative, *Investment for African Development: Making it Happen* (2005).

C. PPPs and the Developing World

Since the early 1990s, PPPs have been implemented in various sectors and with varying degrees of success in almost all developing countries.[72] They have become common as a result of the well-documented inefficiencies of SOEs in the infrastructure sector where it was estimated that public sector

[72] Ibid.

monopolies in energy, road, water and rail in developing countries generated losses of US$55 billion a year.[73] According to the OECD, between 1990 and 2003 there were over 2750 projects involving private participation in infrastructure in developing countries, with total public and private investment in these projects amounting to US $786 billion.[74]

Although PPP agreements have become increasingly common throughout the developing world, the OECD reports that private investors in infrastructure have favoured certain countries over others, generally those with 'relatively large, wealthy or fast-growing markets'.[75] The top 25 destinations for investment in PPPs in infrastructure together account for almost 90 per cent of total PPP investment in the developing world, and the 64 countries at the bottom of the list account for only 1 per cent of total investment in PPPs in developing and transition economies since 1990.[76] PPPs have been most prominent in Latin America, reflecting the greater degree of economic liberalization undertaken in most of that region.[77] The IMF further notes that PPPs have been more common in Latin American countries because of the relatively strong institutional framework that is necessary for the successful establishment and execution of a PPP.[78]

D. Challenges in Designing a Successful PPP Project

Formidable contracting problems arise both *ex ante* in negotiating and drafting the initial contract and *ex post* in ensuring compliance with its terms and in renegotiating the contract at relevant contract renewal junctures. It is important to keep in mind that these problems exist in all PPP arrangements, but that their impact and impediment is often amplified in developing countries where governments often lack the information, expertise, resources and capacity to deal with these problems, and may be in a position of inequality of bargaining power vis-à-vis the private sector partners.

The OECD identifies three principal challenges in designing successful projects: (i) competition in the awarding of contracts; (ii) falling demand and consumer dissatisfaction; and (iii) non-compliance with contractual

[73] Philip Gray, *Private Participation in Infrastructure: A Review of the Evidence* (World Bank: 2001) at 1.
[74] OECD, *supra* note 70.
[75] Ibid.
[76] Ibid.
[77] Ibid.
[78] IMF, Fiscal Affairs Department, *Public–Private Partnerships* (Washington DC: IMF, 2004).

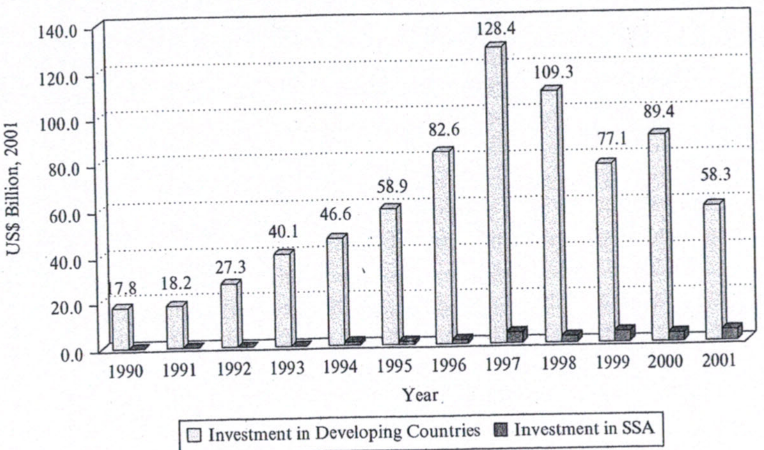
terms. In terms of the first challenge, when the host country is a developing country and lacks the administrative capacity to properly evaluate and award contracts, a large number of project negotiations are often abandoned. According to one source, cited by OECD, only 11 per cent of potential investment negotiations were concluded.[79] Such a dismal probability of concluding projects may render bidding uncompetitive which, in turn, undermines the very purpose of creating PPPs. A World Bank study estimates that the typical number of bidders for a project in the transport sector is two or three – a level that may not be sufficient to elicit strong competition, nor likely to engender significant innovation.

The second challenge is failing demand and consumer dissatisfaction. In order to gauge consumer demand properly, market research is necessary, which many developing countries simply do not have the resources to undertake. Moreover, while stable macroeconomic conditions are crucial for the success of PPPs, many developing countries experience macroeconomic shocks, such as currency crises, which can impede the likelihood of successful project completion and operation and compromise investor confidence in the country. Moreover, given that the primary concern of PPP investors is post-investment cash flow, which is largely dependent on macroeconomic conditions, unfavourable shocks may render the project no longer profitable without a price change.[80] Large fluctuations in prices, in turn, will lead to consumer dissatisfaction, which can further impact on the ultimate success of the PPP.[81]

The third challenge arises when contractual terms are not adhered to. This may be related to public resistance, political circumstances, macroeconomic shocks, or may be as a result of one party's inability to comply with the contractual terms. Often, when the private party cannot comply with the negotiated terms it is because it has understated the expected costs in order to win the contract and subsequently claims 'special circumstances' to demand a variation of the contractual terms.[82]

In the light of these problems it comes as no surprise that the number

[79] OECD, *supra* note 70 at 20. See also D. Jamali, 'Success and failure mechanisms of public private partnerships in developing countries: insights from the Lebanese context' (2004) 17 *International Journal of Public Sector Management* 414.
[80] OECD, *supra* note 70 at 21.
[81] Recent prominent examples include Bolivian water projects: see Willem Assies, 'David versus Goliath in Cochabamba: water rights, neoliberalism and the revival of social protest in Bolivia' (2003) 30 *Latin American Perspectives* at 19; and Lebanese mobile phone concessions: see Jamali, *supra* note 79.
[82] OECD, *supra* note 70 at 22.



Source: World Bank PPI Projects Database.

Figure 6.1 PPI projects entered into by developing countries, 1990–2001

of PPPs that developing countries have entered into has been declining in recent years, as is shown by Figure 6.1. Indeed, in 2005, infrastructure projects involving PPPs were back to the level of a decade earlier.[83]

VII. CONCLUSION

Privatization was originally conceived as a strategy to address the inefficiencies that generally plague SOEs, attract much needed private investment to poor economies and mitigate the fiscal deficits that were crippling developing countries. It was believed that the revenues from the sale of SOEs, together with the reduced need for governmental investment in inefficient and often unprofitable companies, would promote fiscal responsibility and might allow governments to channel available resources to other sectors, such as education or healthcare. The outcomes of the privatization process in the 1990s, however, fell short of achieving these objectives.

This chapter has provided some insights into the reasons for these pitfalls. Evidence shows that richer countries benefit more from privatization than poorer countries. In some cases, privatization can only be successful

83 Ibid., at 7.

if properly coordinated with significant private sector reform, which would entail the creation of credible competition policies and regulatory structures, macroeconomic stability and the reduction of corruption. This means that a country's broader institutional environment will be an important factor in the success of privatization processes. This broader institutional environment can also impact on the political feasibility of privatization.

However, even if the broader institutional environment is in place, and there is political willingness to move forward with privatization, the institutional details of the privatization process still present a formidable set of challenges. The chapter has illustrated this issue with an analysis of the costs and benefits of major privatization strategies, such as restitution and voucher, privatizations, management buy-outs, outright sale of state property and partial privatizations. The chapter also considers the advantages and disadvantages of alternatives to privatization, such as management contracts, performance contracts, increased competition, and public–private partnerships in the context of new infrastructure projects.

This chapter has underscored the point that there are important interconnections between privatization and other elements of the broader institutional environment. For instance, a healthy private sector with robust competition requires a well-functioning financial system, an appropriate regulatory framework depends on a competent and non-corrupt bureaucracy, and a stable macroeconomic environment depends on a functional and competent central bank (inter alia). In addition, privatization itself is a challenging exercise in detailed institutional design requiring high levels of legal, financial and management expertise, which many developing countries lack. While this expertise can often be obtained externally, external consultants often lack the detailed knowledge of a developing country – its history, culture and politics – to provide relevant advice, thus rendering external expertise an imperfect substitute for indigenous expertise in the long run (although combinations of indigenous and external expertise may be a short-term solution).

7. International trade, foreign direct investment and development

I. INTRODUCTION

In the next two chapters, we address features of the international economic order that bear importantly on the economic prospects of developing countries: – trade and foreign direct investment in this chapter, and foreign aid in Chapter 8.

To put these features in perspective, global exports from developing countries amounted to US$1 717.7 billion in 2000.[1] In 2008, investment inflows to developing countries reached US$517 billion,[2] and official development assistance (foreign aid) US$119.8 billion.[3] These figures show that international trade and foreign direct investment (FDI), are clearly the most substantial sources of external income for developing countries.

From the perspective of developed countries, they can either import goods or services from low-wage developing economies (like China or India), or they can maintain very liberal immigration policies with respect to not only skilled workers but also unskilled workers, and maintain relatively low-wage industries in developed countries. Alternatively, they can view trade and FDI as complements and invest in manufacturing facilities in low-wage developing countries and use these as an export platform either to their home country or other developed or developing economies around the world (as exemplified by the growth of global supply chains and intra-firm trade). Or, again, they can view trade and FDI as

[1] William R. Cline, *Trade Policy and Global Poverty* (Washington DC: Peterson Institute, 2004) at 20.

[2] UNCTAD, 'Assessing the impact of the current financial and economic crisis on global FDI flows', 19 January 2009, available at http://www.parl.gc.ca/Content/LOP/ResearchPublications/prb0710-e.htm.

[3] Jennifer Paul and Marcus Pistor, 'Official development assistance spending', 13 May 2009, Parliamentary Information and Research Service Library of Parliament. Available at http://www.parl.gc.ca/information/library/PRBpubs/prb0710-e.pdf.

substitutes and, instead of exporting to large developing country markets, invest in manufacturing facilities in these countries to service their domestic markets.

From a developing country perspective, emigration is a poor substitute for trade in that developing countries risk losing their most highly skilled workers to developed countries through a brain drain – which is, to some extent, offset by the substantial remittance flows that expatriates often send back to their home countries (estimated to be in excess of US$300 billion per year), and sometimes also offset by trade and investment networks that develop between home countries and diasporas in developed countries (Silicon Valley in the United States, for example).[4] As to whether trade and FDI are substitutes or complements, FDI may provide the capital and technical and managerial expertise required to promote major export-oriented sectors in developing countries and hence are complements, but this will entail host countries sharing the benefits of these investments to a greater or lesser extent with the foreign direct investors involved (as will be explored later in this chapter). Where import substitution policies are adopted by developing countries, trade and FDI are likely to be substitutes.

II. TRADE AND DEVELOPMENT

A. Trade Policy and Development: An Historical Perspective

International trade has a long history, both in terms of intellectual thought[5] and in terms of actual practice. Countries, or more accurately merchants in these countries, have been trading with each other for millennia;[6] however, it was not until the Enlightenment and the writings of political economists – such as Adam Smith in *The Wealth of Nations*[7] and David Ricardo in *The Principles of Political Economy*[8] – that the basic

[4] See Michael Trebilcock and Matthew Sudak, 'The political economy of emigration and immigration' (2006) 81:1 *NYU Law Review* 234. Ian Goldin, Geoffrey Cameron and Meera Balarajan, *Exceptional People: How Migration Shaped Our World and Will Define Our Future* (Princeton, NJ: Princeton University Press, 2011).

[5] See Douglas Irwin, *Against the Tide* (Princeton, NJ: Princeton University Press, 1996).

[6] See Nayan Chanda, *Bound Together: How Traders, Preachers, Adventurers and Warriors Shaped Globalization* (New Haven, CT: Yale University Press, 2007).

[7] Adam Smith, *The Wealth of Nations* (1776).

[8] David Ricardo, *The Principles of Political Economy* (1817).

economic theory of international trade was first formulated. Adam Smith emphasized the gains from specialization and that these gains were limited only by the extent of the market. He pointed out that very few families find it economically rational to produce all the goods and services that they require, but in fact they produce goods or services for some of their needs and otherwise purchase goods or services from others who are better qualified to provide them. Smith argued that, just as this makes sense in the case of the family, it also makes sense in the case of a nation. It is easy to appreciate the force of this argument for free trade within nation-states. For example, in a large federal state like the US, Michigan specializes in producing automobiles (*inter alia*), Florida citrus fruit and tourism, Texas oil and beef, and California wine and high technology products. If each state of the US were to have attempted to become self-sufficient in these and all its own needs, the US would today be immeasurably poorer. It equally follows, on Smith's theory, that similar specialization is likely to generate mutual gains from trade in international exchanges – the division of labour is limited only by the extent of the market. According to Ricardo's theory of comparative advantage, countries should specialize in exporting goods where their comparative advantage is greatest and import goods where their comparative disadvantage is greatest, implying that all countries will find it advantageous to trade with other countries, even though they may lack an absolute advantage in any product.

It is conventional wisdom amongst trade scholars that a liberal world trading system in which countries are free to exploit or develop distinctive forms of comparative advantage is a key to increased productivity, economic growth and development. This thinking was evident in the original Bretton Woods Agreement which gave birth to the post-war international economic architecture, including the IMF, the World Bank and the GATT. In other words, conventional economic thinking was that, with the emergence of a liberal world trading system, a rising tide would lift all boats. Unfortunately, this has not proven to be the case. As Williamson shows,[9] over the past two centuries there has been a dramatic divergence in incomes around the globe, which has been driven overwhelmingly by the rise of between-country rather than within-country inequality.[10]

A number of developing countries have successfully integrated themselves into the world trading system and have benefited enormously from

[9] Jeffrey Williamson, 'Winners and losers over two centuries of globalization' (2002) World Institute for Development Economics Research Annual Lecture (WIDER) at 9–10.

[10] See more generally Branko Milanovic, *Worlds Apart: Measuring International and Global Inequality* (Princeton, NJ: Princeton University Press, 2005).

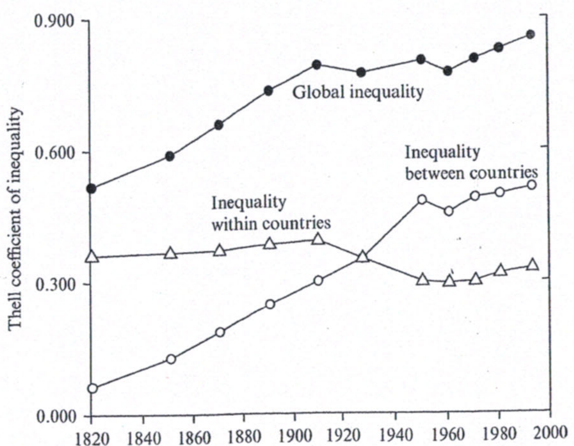


Figure 7.1 Global inequality of individual incomes, 1820–1992

it (the most prominent contemporary examples being China and India). However, many other developing countries have largely been left behind by the process of globalization. In *The Bottom Billion*,[11] Paul Collier documents the stagnation or absolute decline in real incomes of a number of very poor countries around the globe: most are concentrated in sub-Saharan Africa, but a number are located in Central Asia and Latin America, which are home to the bottom billion of the world's population, living on less than one dollar a day. These countries – about 60 on Collier's count – comprise almost a third of the countries in the world (mostly small) and one-sixth of the world's population. While foreign aid sometimes mitigates their economic decline, minimal exports and foreign direct investment preclude significant growth. According to Collier, these are countries caught in various traps – the conflict trap, the natural resource trap, the landlocked with bad neighbours trap, and the bad governance trap.

The multilateral trading system has not been oblivious to the special economic challenges facing developing countries.[12] Almost from the beginnings of the GATT in 1947, developing countries were accorded a

[11] Paul Collier, *The Bottom Billion* (New York: Oxford University Press, 2007).

[12] For useful introductions to the GATT/WTO, see Bernard Hoekman and Petros Mavroidis, *The World Trade Organization: Law, Economics and Politics* (London: Routledge, 2007); Michael J. Trebilcock, *Understanding Trade Law* (Cheltenham: Edward Elgar Publishing, 2011).