Government of Spain-UNDP MDG Achievement Fund (MDG-F)

Terms of Reference for the Thematic Window on

Democratic Economic Governance

This document provides policy guidance to UN Country Teams applying for funding under the UNDP-Spain MDG Achievement Fund (MDG-F) Thematic Window for **Democratic Economic Governance**. The framework elaborated below aims to set out the policy goals of the Fund in this area and illustrate the types of interventions the Fund will support. This guidance will also be applied by the technical assessment process that will review applications. These Terms of Reference should be read in conjunction with the Fund's "**Framework Document**" which sets out the overarching strategy for the MDG-F and the "**Concept Note Format**" which provides the format for submissions. These can be viewed at the Fund's home page at www.undp.org/mdgf. Kindly note that MDG-F Thematic Windows will only accept applications from UN Resident Coordinators in eligible countries, applying on behalf of their UN Country Team.

Background and rationale

Meeting the Millennium Goals depends on the promotion of sustainable and pro-poor economic growth. Pro-poor growth requires the involvement of the poor and vulnerable in decision making on the public policies that determine the rate and pattern of growth. They need to be informed about the issues, and to have ways of accessing the debates and influencing the decisions that have repercussions on the extent to which they can participate in, contribute to and benefit from, growth. The goal is to achieve a pro-poor growth pattern that will result in a reduction of the many dimensions of poverty that affect them.[i]

Democratic economic governance can be seen as the exercise of democratic principles and good governance practices in political and economic decisions involving the management of public funds, resources and affairs. Good governance ensures that the voices of the poor and vulnerable are heard. The interaction amongst all stakeholders – the state, private sector, and civil society – influences the extent to which political and economic institutions and processes deliver for all, especially the poor.

There are four key dimensions to strengthening democratic governance in support of development and poverty reduction:

- First, to strengthen the capacity and ability of the poor to participate and influence the processes of reform through which national development strategies aimed at poverty reduction are designed and implemented. It is particularly important to empower the poor through participatory processes with real influence on policy design and implementation. Although this is essential, it is not sufficient to achieve pro-poor growth, given that the success of reforms depends on other factors beyond empowering the poor.[ii]

- Second, to encourage a broad public-private dialogue, including with civil society, when conceiving and implementing public policies and reforms aimed at pro-poor growth. It is essential to augment the range of voices with influence in these dialogues, enriching the representation of both the private and public sectors. It is equally important, at both the local and national levels, that this varied participation be operational in nature and concentrate on specific policies and initiatives that include the perspective of the poor.
- Third, that the political, economic, and institutional reforms be sustained by a "social contract" that focuses on generating pro-poor growth, in which the poor participate and benefit. This implies a need to enable the poor to participate and intervene in the actual process of formulation of public policies. Institutional or political reforms should be based on specific changes that benefit the poor. The costs – if any – and the effects that this "pro-poor" focus will need, should be explicitly considered, and the social contract should provide the basis for deciding if and how society is prepared to bear those costs. Fostering this social contract is crucial for the stability and continuity of the reform process. This contract will certainly be reinforced by measures to empower the poor and by a state that is responsible, open to dialogue and transparent with the private sector and civil society.
- Fourth, the reform process should be based on a long-term programmatic strategy for reducing poverty that is duly adopted by the government and supported by society at large. The goal is for the poor to have the sufficient strength and ability to influence the definition of policies within national development strategies, without obstructing other social forces, in order to ensure that economic governance effectively contributes to reducing poverty and hastening the achievement of the MDGs. These national development strategies can be important tools for strengthening the social contract, which is the basis for the reforms needed to ensure that the poor are included in, and benefit from, growth.

Achieving pro-poor growth involves a wide-ranging and complex set of tasks. Within the thematic window of democratic economic governance, the Fund focuses on infrastructure development, aiming at ensuring that the governance of public services makes political decision makers and service providers responsive to the preferences and aspirations of the population, and especially the poor and vulnerable. It can also support activities to develop the private sector, including actions to mitigate the vulnerabilities and risks that the poor are subject to and to improve their integration into the economy.

Key challenges and opportunities in this sector

The democratic economic governance of utilities is a critical challenge for developing countries because universal and affordable access to such services is crucial for progress towards the Millennium Development Goals (MDGs). The 2006 UNDP *Human Development Report* (HDR) highlighted how lack of access to safe drinking water and sanitation may constitute a barrier to achieving several MDGs. Enhanced access is also key for sustained economic growth and sustainable human development. The financing needs for utilities and infrastructure are very large.[iii] But access to finance is only one challenge. Constraints to access, especially by the poor and vulnerable, may often result more from lack of empowerment and deficiencies in the accountability of providers to political institutions – as found in the 2006 HDR on water and sanitation. Key policy challenges in this area, which are elaborated below, may be due to difficulties faced by governments in setting up appropriate regulatory strategies and weaknesses in the broader institutional setting (including a legal framework that ensures accountability to representative political institutions) that ensures stability and equitable access to utility services.[iv]

The policy challenges are framed by: i) the fact that utilities provide key infrastructure for economic development; ii) the importance of equity considerations (which weigh heavily, given concerns with ensuring broad - even universal - access, as in the case of clean water and sanitation); iii) the intrinsic economic nature of utilities (which typically require large, durable, and immobile investments that in combination with strong economies of scale, create a tendency towards a natural monopoly. [v]; iv) the fact that utilities services can have a dramatic effect on the extent to which the patterns of growth are pro-poor, with a potential to contribute greatly to inclusive economic growth and human development. This sets the stage for complex economic and political challenges when it comes to building, expanding, monitoring, and operating utilities, among the most important of which are the following:

- **Institutional setting:** The broader institutional setting that governs political and economic processes (including the dynamics of political competition, the regulation of economic competition, the effectiveness of courts and arbitration in addressing contract disputes) and the capacity of the government, institutions, and civil society, determine the type of regulatory strategy that is more effective; there is no one strategy that is more appropriate in all contexts. Therefore, monitoring the outcomes and ensuring continuing accountability of utilities to representative institutions are key. If utilities fail to deliver, how can the usual democratic channels correct these public policy problems? How can we ensure that the utilities are contributing to pro-poor growth? What are the channels of redress, if any? How can regulatory mechanisms help? Who may be appointed as the watchdog of public values and how can they report to the government? What are their powers over the industries?

- **Regulatory strategy:** One fundamental challenge is to decide upon the regulatory strategy that frames the interaction between the government, the utility, and the consumer. The intrinsic economic nature of utilities – requiring large, durable, and immobile investments – implies that the government, the supplier (which can be either privately or state-owned, or a combination of both), and the consumer are all vulnerable to each other. Thus, good regulatory strategies will ensure stability and commitment to all involved, with incentives that lower the likelihood of politically-motivated short-term shifts in policy and opportunistic behavior by incumbent suppliers. But framing this challenge along these lines just opens it up to a wider set of narrower challenges, including:

    - **How to decide on the level of involvement of the government, from direct provision, at one extreme, to fully liberalized private-provision, at the other?** Some of the relevant trade-offs include weighing the efficiency costs of retaining public delivery against the transaction costs of relying on purely private transactions. Are the conditions for adequately regulating private competition in place? Options in-between, including concessions and regulation of private provision, also create problems. Information asymmetries between the regulatory agency and the supplier may distort prices and levels of service. Even if the delivery remains with the public sector, issues of information asymmetry may emerge with public oversight of a public supplier.

- **How to balance commitment with flexibility?** Over the course of the life of a utility investment, many changes in technology, markets, politics and society can occur. While commitments are important, some degree of flexibility is also required. Indeed, the regulatory framework should create incentives for competition and innovation, not the opposite. When a government regulatory agency is established to regulate a private supplier, avoiding regulatory capture can be a major concern. But there is no clear guidance on where to set the dividing line between technocracy/independence and discretion.
- **Meeting information needs**. One critical challenge involving many utilities is the availability of information. What is the cost and quality of the services provided? Gathering this type of information is a requirement not only to start any process of reform, but also essential for the on-going monitoring and evaluation of the process. Access to information about quality of service-delivery determines citizen effectiveness in supporting government accountability systems but also shapes their capacity to make difficult choices – where these are possible at all – about seeking alternative suppliers, and thus enhancing competition.
- **Balancing efficiency with equity**. How to balance the efficiency and sustainability of the service with the potential of generating social inclusion around the participative process of defining public services policies, and provisions and the monitoring and accountability of utilities.

- **Goal setting:** Even the most ‘perfect’ regulatory strategy may ultimately fail if the objectives that it was set to deliver were misguided at the outset. What are the efficiency goals (cost reductions, increase in the reliability of the service) and social welfare objectives (not only individual benefits, but also the externalities expected for example, in public health or increased economic activity)? How do these goals reflect public values? Lack of effective participation may lead to goals that do not reflect public aspirations, especially of the poor and the most vulnerable, with an optimal regulatory strategy thus ‘under-delivering’ in the public’s eyes. Goals can also be over-optimistic, leading to unsustainable processes that may contribute to a negative backlash against the reforms.

- **Meeting financing needs**: Even with well-defined and publicly consensual goals, along with perfect regulatory and monitoring strategies, the nuts and bolts of financing the investment and operation of the utility are a challenge. How to balance universal access with financial viability (be it fiscal sustainability by governments or private returns to service delivering firms)? How to extend access and raise quality of services to the poor and to those currently excluded, while ensuring that enhanced access is affordable to consumers and financially viable for suppliers? In most contexts, meeting the financing needs will require accessing all possible sources of resources (public and private, domestic and external) and involve risk management, through risk mitigation and appropriate and efficient risk-sharing approaches.

- **Ownership and Complementarity with the National Development Agenda:** The Paris Declaration on Aid Effectiveness defines the principles that should rule a strategic association with a partner country in order to maximize the effectiveness of aid delivery. Interventions in the area of utilities in a partner country must be coordinated with the National Development Strategies, aligned with national investment plans, and articulated with other donor initiatives.

- **Dealing with dislocation:** Even if all of the above goes well, economic, social, and political dislocation may occur when a process of change in the current status quo of utilities takes place. Some people may lose jobs, individuals in privileged positions may lose power and income, prices may have to increase for some (or taxes, if not prices), all sorts of externalities (including environmental impacts) may take place. Managing and dealing with this set of dislocations may go beyond the scope of setting-up well-run, efficient and effective utilities, but ignoring this may impede setting-up the process in motion to begin with – or lead to reversals afterwards.

The MDG Achievement Fund seeks to support interventions that enhance access to, and provision of, services by utilities, increasing their efficiency and affordability at either a national or local level, and taking into consideration how the poor participate and benefit from these services.

Illustrative interventions

Within the framework of democratic governance, the MDG-F will welcome funding applications that aim to:

- **Improve efficiency, access, affordability and quality of services provided by utilities at the national and local level;**
- **Foster inclusive participation in decisions relating to public utilities, empowering the poor, women, youth and the marginalized;**
- **Promote core democratic governance principles of equal representation, accountability and transparency at the national, regional and local levels, in economic policy making and governance;**
- **Develop and foster innovative partnerships with the private sector.**

To achieve these goals, proposals could contain some or all of the following illustrative elements:

- **In-depth analyses - "Know-thy-challenge"**: All proposals from UN Country Teams must justify their interventions based on a prior formulation of a diagnosis identifying the general issues and constraints. The formulation of ex ante evaluations of the impact of the proposal on poverty reduction will be welcomed, following, for example, the methodologies of the World Bank's Poverty and Social Impact Analysis (PSIA), or the ex-ante Poverty Impact Analysis (PIA) from OECD DAC.

- **Adapting regulatory strategies, institutional frameworks and incentive structures to enhance quality and widen access**. When the diagnosis is robust and supportive of more concrete steps, interventions might consist of upgrading or changing the regulatory strategy. This may include enhancing technical capabilities in oversight or regulatory agencies through training. Changes in regulatory strategies may include developing innovative concession contracts, advancing with hybrid public/private delivery models, implementing price-caps or cost-of-service regulation. Such interventions should explicitly address how they will seek to deal with the challenges related to incentive structures that promote policy stability and commitment, while being responsive and accountable to political institutions. The proposals should spell out what are the entities that are technically independent and the mechanisms through which political accountability and the participation of the public is to occur. Proposals could also establish mechanisms of consumer protection, which could include institutions of consumer advocacy and protection.

- **Reducing information asymmetries to enhance legitimacy**. Interventions may provide support to government (the executive and/or legislature) and civil society to ensure that the process through which policy change is being implemented is open, transparent, credible, and participatory. This may include support for public consultations, media outreach, and empowerment of civil society to engage in debate. If the goal is to decrease information asymmetries and agency problems, a regulator can use competitive bidding and yardstick competition to encourage firms to reveal information. It can also call on fees and penalties, price regulation, the use of short-term contracts including re-bidding clauses in longer term contracts. Such measures are likely to facilitate monitoring both by the government and by the population at large.

- **Managing financial resources and incentives for enhanced access**. Interventions might use subsidies to directly extend access, or to partner with private and other actors for the same purpose. They may also include seeking advice on the most efficient ways to use potentially freed-up resources from efficiency gains to guarantee enhanced access by the poor. This could include assistance in the establishment of price mechanisms or the creation of customer cooperatives to serve as "price regulators". If privatization is the option pursued, proposals could also explore ways to promote ownership in privatized utilities to make consumers shareholders. Interventions could include efforts to strengthen the negotiating capacity of governments seeking to enter into arrangements with private sector providers – including through public-private partnerships (PPPs). In this latter case, support for establishing PPP units within the government could also be considered.

- **Stimulating private sector development**. Proposals may assist in introducing legal frameworks to encourage private investment, expand access to secure rights to economic assets for the poor at both community and individual level, and to expand local participation in service delivery.

- **Dealing with economic and social dislocation**. Proposals may include interventions to support those that are "dislocated" by the process of reform. Particular attention should be given to sectors that might have the greatest impact on women and marginalized segments of society.

Across all of the above areas, the Fund will naturally seek to promote initiatives that are sustainable in the long-term and that take into consideration their potential economic, social, political, and institutional implications.

How will we know we are having an impact?

Programmes financed by the MDG-F in this sector, will be expected to demonstrate credible, measurable results. Applications to the Fund will therefore be required to identify the key indicators that can be used to measure and monitor success of the programme and the means to collect that data during and after the proposed programme period. Some of the indicators that should be considered in formulating proposals in this field would include measures of access to utility services such as changes in coverage rates, changes in access among those previously excluded and among those at the bottom of the income distribution, especially access by the poorest women. Impact could also be assessed through changes in the efficiency of the delivery of public services, as measured by changes in prices and the cost of delivery. In addition, tracking satisfaction with service delivery, as measured by surveys and the results from consultative initiatives, would highlight the sustainability of the process.

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[i] OECD, 2006; *"Promoting Pro Poor Growth: Key Policy Messages"; DAC Network on Poverty Reduction*

[ii] Botchway, Karl, 2001; "Paradox of Empowerment: Reflections on a Case Study from Northern Ghana"; World Development Vol.29, No.1, pp. 135-153.

[iii] Estimates suggest that for 2005-2010 middle-income countries require 5.5%-7.0% of GDP and low-income countries require 7.5%-9.0% of GDP to meet their utility investment needs. Briceño-Garmendia, Cecilia, Antonio Estache and Nemat Shafik. 2004. "Infrastructure Services in Developing Countries: Access, Quality, Costs and Policy Reform". World Bank Policy Research Working Paper 3468. World Bank, Washington, D.C.. The OECD estimates that for 2005-2010 the total annual investment needs for utilities in middle-income countries will be $356 billion and for low-income countries $109 billion, with Africa alone requiring $17-20 billion per year. OECD (Organisation for Economic Co-Operation and Development). 2005. "The DAC Guiding Principles on Infrastructure for Poverty Reduction". Draft – August 2005. Paris.

[iv] For the importance of the broader political context for the effectiveness of regulatory strategies see Pablo Spiller and M. Tommasi. 2003. "The Institutions of Regulation: An Application to Public Utilities." Handbook of Telecommunications Economics. See also Inter-American Development Bank. 2006 *The Politics of Policies – Economic and Social Progress in Latin America* (Chapter 9).

[v] Other reasons for government involvement in utilities include the difficult in assembling the right of way that is often required for utilities infrastructure and the fact that the consumption of services provided by utilities often creates vast externalities (e.g. the benefits of safe drinking water and of sanitation for public health). This discussion draws on Gómez-Ibañez (2003).