

Roundtable on Financing Water

The Roundtable on Financing Water

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Session 3. Strategic Investment Pathways

BACKGROUND PAPER

REFLECTIONS ON THE POLITICAL ECONOMY OF WATER INVESTMENT

Fabiana Velasques de Paula Machado, Inter-American Development Bank

1. Reflections on the Political Economy of Water Investment

One of the strongest messages in recent work about infrastructure development is that great progress can be made by spending better, rather than increasing spending alone. Spending better is not only about doing more with less, but, given the current inefficiencies, also about freeing up resources for more productive uses. Both have important implications for estimating spending needs and identifying opportunities.

While the Latin American and Caribbean region faces many challenges requiring new investment, there is also a need to improve the efficiency with which existing investments are being translated into outcomes. From a political economy stand point, these two critical decisions (where to spend and how) are characterized by important trade-offs that shape the incentives faced by decision makers. From the institutional set up all the way to the perceptions and attitudes of the population, these factors are key to understanding the challenges and the opportunities for water financing. Yet, data and scholarship on such issues are rather scant.

1.1. Background

A key message from the IDB's flagship publication "Better Spending for Better Lives"¹ is that there is room to increase both technical and allocative efficiency in public spending in the Latin American and the Caribbean (LAC) region. When it comes to allocative decisions, spending on direct social transfers have been increasing, while longer term investment, such as infrastructure, have been losing ground. The latter is usually the first to experience cuts when governments are faced with the need to reduce spending. The analysis also reveals a potential gain of 4.4% of the GDP from addressing inefficiencies in public spending.

This reality of suboptimal choices of where to spend and how to go about it is not only true of public spending in general, but also of spending within specific sectors and their sub-sectors. A study by McKinsey in 2013 argues that compared to a business-as-usual baseline, there is room to save about 40% of what is invested in infrastructure globally by better selecting projects and improving the efficiency of project delivery and asset usage².

Research by the World Bank echoes similar messages. In *Beyond the Gap*, it is argued that infrastructure investment needs depend both on the goals countries decide to pursue – e.g. meeting the SDG's, treating 100% of its wastewater, reducing resource waste – and the way they choose to pursue them – e.g. individual versus centralized treatment solutions, single versus combined technologies and instruments. Moreover, the report emphasizes that investment is only part of the equation, maintaining the infrastructure is crucial to achieving the intended goals. This means several important decisions need to be made that have significant consequences to the costs of water related projects, but also to the likelihood of these projects being successful³.

¹ Inter-American Development Bank. (2018). *Development in the Americas: Better Spending for Better Lives*. Washington D.C.: Inter-American Development Bank.

² McKinsey & Company. (2013). *Infrastructure productivity: How to save \$1 trillion a year*. The McKinsey Global Institute

³ Rozenberg, J., & Fay, M. (2019). *Beyond the Gap : How Countries Can Afford the Infrastructure They Need while Protecting the Planet*. Washington D.C.: The World Bank.

One of the fundamental characteristics of the water sector that greatly contributes to its complexity is the haphazard attribution of decision-making power. There are many levels of government and types of entities with a say in how water is abstracted, allocated and returned to the environment. While some of the incentives associated with decision-making are common across these many actors, their variety and sometimes overlapping roles make it a complex political economy problem.

1.2. Politics and Decision-making

A core set of accepted “best practices” exists about how to organize and manage the sector. Yet implementing them is an enormous challenge. A critical bottleneck to their adoption relates to disincentives that can come out of the political process. The broader literature on political economy has identified several ways in which the political process can discourage the adoption of policies deemed optimal from a “benevolent social planner” point of view. Many of these insights are applicable to the water sector and can shed light into the issue.

When dealing with democracies, a natural starting point is to understand how the quest for votes can influence government priorities, policies and spending decisions. The canonical way to garner votes is to cater to the interests of the majority. With a multidimensional policy space and one vote, individuals are forced to prioritize among their competing interests. It is thus the relative, rather than the absolute, importance of these interests that will likely affect political decisions. In that race for attention, infrastructure and the environment suffer. While directly affecting the day to day lives of every citizen, they are rarely considered government priorities by individuals in the region. Concerns about the environment and infrastructure usually lag far behind those about the economy, jobs, violence, corruption or social issues, such as health and education. In a voting experiment conducted with a representative sample of the Brazilian and Mexican populations, a candidate running on an infrastructure platform gathered almost 15% fewer votes than the same candidate running on a platform focused on job creation. The corresponding loss for a candidate running on a platform to protect the environment was 20%⁴.

Prioritizing policies and goals is no easy task for individuals. But there is still much we need to learn about how they make such decisions. Hypotheses about how citizens may fail to coincide in opinion with experts abound. Although most remain unsubstantiated by hard evidence. While people cannot be experts in most areas of political relevance, basic awareness and information are key factors in opinion formation that can be addressed through campaigns and targeted interventions. In the case of water, targeting the young generation in ways compatible with their culture has met with some success – e.g. in sanitation⁵ and the environment⁶.

⁴ Machado, F., Huberts, A., & Kearney, M. (Forthcoming 2019). Issue-Voting in Perspective: Cojoint Analysis of Personal vs. Policy Attributes in Vote Choice.

⁵ One Drop. (2019). *Supporting behaviour change and strengthening the WASH sector in the state of Guanajuato*. Retrieved from <https://www.onedrop.org/en/projects/mexico/>

⁶ Swarovski. (2019). *Water Schools*. Retrieved from <http://www.swarovskiwaterschool.com/locations/brazil>

In addition to individuals' opinions, their levels of confidence in government institutions and their ability to clearly assign responsibility potentially mediates their propensity to pressure governments for action. Given the organizational complexity of the sector and the low levels of trust in government that are characteristic of the region, this process of political accountability may suffer. Lack of faith in the capacity of governments to listen to and respond to citizen demand can deter efforts to bring matters to their attention, by lowering the expected return from such effort.

From the perspective of decision-makers, earning votes in such a context may require actions that are clearly visible to voters or whose benefits are directly and easily perceived. If that is the case, decision makers are encouraged to prioritize direct transfers, rather than long term investments that take time to yield benefits. They may also favor new construction over spending on maintenance of hidden pipes or on the protection of watersheds. Moreover, given the prevalence of pocketbook voting – that is voting for the candidate that provides the highest financial benefit – political decisions over water pricing and tariffs risk being skewed towards low levels that can threaten cost-recovery and the rational use of the resource.

Successful strategies to earn votes, however, are not limited to catering to the policy interests of the electorate. The practice of vote-buying, for example, is not uncommon in the region. The currency used to build what became known as “clientelistic” ties varies with context, but often takes the form of private goods that can meet low income individuals' basic needs, such as shoes and construction material. In dry regions characterized by poverty, lack of water has been identified as an important element in the vulnerability of households and therefore an important currency (easily targeted by water trucks) in clientelistic relationships. A study in the Northeast of Brazil found that the delivery and installation of rainwater harvesting kits in poor households lacking access to formal service was associated with a significant decline in clientelistic ties to local politicians. This means the provision of water services has the potential to improve the functioning of democratic systems, in particular for the vulnerable population.⁷ However, a key aspect of such strategies, as highlighted in the literature, is the incentive to keep families in a state of need. In the example about water, this means an incentive for service under provision. There is still however much we need to learn about how individuals weigh private goods versus policy in making their voting decisions.

The pursuit of votes is not the only goal of elected representatives, especially once they win elections. There are many pecuniary and non-pecuniary benefits to holding office. One may cater to private interests in search of campaign contributions or for one's own benefit. Rent-seeking has been a standard assumption in economic models of the political process and carry important implications for the water sector. Given the incentives identified so far, a political strategy based on setting service tariffs below cost-recovery and relying on supply side subsidies, would be consistent with pleasing voters and generating opportunity for rent. Reversing this equilibrium hinges on voters perceptions of the quality and the value of the services they receive and on the levels of trust on government and the utility. A strategy of first increasing tariffs to finance improvement in services can be politically unwise, specially if both service quality and trust levels are low. Other financing mechanisms are likely to be needed in order to boost confidence and service valuation, so that a new equilibrium of higher tariffs and sustainable services can be established.

A similar logic could be at work in the decision between adopting gray versus green infrastructure. Gray infrastructure tends to be widely accepted and involve higher financial transactions. Both could increase

⁷ Bobonis, G., Gertler, P., Navarro, M., & Nichter, S. (2019). *National Bureau of Economics Research*.
Fonte: <https://www.nber.org/papers/w23589.pdf>

its political appeal. Transparency seems key to alleviating these kinds of bottlenecks. Quality data and information that are made public can increase popular awareness and also foment more research contributing to evidence-based decision making, in particular about the merits and shortcomings with different ways of achieving a stated goal.

Alongside political exchanges between candidates and the electorate lies another important constraint to the implementation of policies considered to be optimal. That is the level of institutional and technical capacity available for designing, implementing and monitoring policy decisions. Absent or weak regulators hinder the design, implementation and enforcement of sector guidelines and quality standards. Lack of data and information processing capacity prevents evidence-based decision-making. A poor match between responsibilities and required technical training can lead to suboptimal policy choices or project selection. In other words, the available institutional capacity will greatly affect the range of policies that can be successfully implemented in addition to generating low incentives for accountability. A complex means-targeted demand side subsidy, for example, is impracticable in the absence of up to date microdata and analysis. Similarly, the selection of appropriately tailored projects to specific conditions may lead to poor choices if the technical knowledge required to evaluate and rank proposals is absent. In fact, poor selection of rural sanitation projects due to lack of technical capacity of evaluators has been an often cited cause of project delays and suspensions in Brazil, according to a study of the performance of rural sanitation projects financed by the federal government⁸.

Again, more data and information can help clarify and quantify the extent of such problems, raise awareness and provide guidance in devising solutions to address them.

1.3. Decentralization

A widespread trend in the region has been to partially decentralize water resources management and fully decentralize the delivery of water services. The devolving of responsibilities, however, came without the accompanying granting of fiscal powers. This dissociation between policy decision and funding capacity means local governments depend on the central government for resources. This disconnect may contribute to its susceptibility to political cycles and alignments and to uncertainty about its frequency and size. Together, these elements hinder the ability to plan and carry out long term investment needs that are critical to the sustainability and good functioning of the sector.

An often praised advantage of decentralization is that it brings decisions closer to citizens. The actual benefits, however, may depend both on the local context and, as previously mentioned, on the priorities and preferences of citizens. Local capacity, and its susceptibility to political capture or clientelism, varies a lot within countries. This means that decentralization can result in significantly different outcomes, with more developed and politically healthy localities likely to display higher success rates. Citizens in urban areas, for example, tend to be more critical of services and more vocal in their demands, which could more easily trigger accountability mechanisms and improved conditions. Decentralization can also further contribute to the marginalization of minorities and the diminishing importance of matters that affect specific and dispersed areas of the country. A national campaign to encourage the universalization of rural sanitation services, for example, could be a lot more successful than relying on local politicians to cater to the interests of a very small and difficult to reach population that provides little return in the form of

⁸ Trata Brasil. (2016). *7 anos de PAC*. Trata Brasil. Retrieved from <http://tratabrasil.org.br/estudos/estudos-itb/itb/7-anos-de-pac>

capacity to pay and votes. Decentralization, therefore, could be contributing to increasing inequalities within countries⁹.

Because most water utilities in the region are public, decentralization has similar consequences to their operation. There tends to be dependency on federal transfers to cover costs, funds that are irregular and uncertain, thus compromising long term planning¹⁰. Political interference in the affairs of the utility can also hinder autonomy and skew incentives away from efficiency and profit, and towards political goals. This is another important area where research is sorely needed. Available datasets that could be used to explore such questions tend to lack representativeness and instruments for quality control.

Partial decentralization of responsibilities coupled with dispersion of authority over water related affairs can also raise important obstacles to sound and efficient decision making. Overlapping jurisdictions can lead to a “status quo bias” resulting from the difficulty of reaching agreements among dispersed actors. It can also raise barriers to accountability through the fragmentation and muddling of responsibilities. This complex institutional landscape is further aggravated by non-corresponding jurisdictions between watersheds – considered to be the optimal level of decision making for water management – and political boundaries. This complex arrangement can result either in inaction or in contradictory rules and goals that undermine compliance and threaten the success of projects and policies.

1.4. Conclusions

The region needs to invest more in water, but also to improve the efficiency and effectiveness of its current investments. There is no shortage of hypotheses about the political economy bottlenecks likely to pervade investment decisions, but a lot more research is needed to build a strong body of evidence that can yield sound policy advice. For that, the region needs to invest in the generation of quality sector data. They are the basis not only for setting and upholding quality standards, but also for encouraging evidence-based decision making.

Questions for discussion

- In light of political economy realities, what strategies have proved successful at improving the efficiency of water-related investment and overcoming “status quo bias” in the way decisions are made?
- What are the priorities for improving the quality and availability of data and evidence to inform water-related investment decisions?
- Considering some of the drawbacks of decentralisation, is there scope for strengthening the role of national governments to shape strategic investments for water and sanitation?

⁹ Bardhan, P., & Mookherjee, D. (2006). Decentralisation and Accountability in Infrastructure Delivery in Developing Countries. *The Economic Journal*.

¹⁰ Lentini, E., & Ferro, G. (2014). *Políticas tarifarias y regulatorias en el marco de los Objetivos de Desarrollo del Milenio y el derecho humano al agua y al saneamiento*. Santiago de Chile: CEPAL.