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## **FIRST PROJECT WORKSHOP**

**Private Sector Participation  
in Water and Sanitation:  
institutional, socio-political,  
and cultural dimensions**

**Paper:**

**“State, Market and Utilities Provision: Economic Theory Perspectives”**

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### **Liberal Political Economics approach**

Classical economic liberalism, from the primary Political Economics, which was developed between the end of the 18<sup>th</sup> century and the first half of the 19<sup>th</sup> century through the works of Adam Smith, David Ricardo, John Stuart Mill and Malthus in England, and Jean-Baptiste Say and F. Bastiat in France (among others), extrapolates the principles of the political liberalism of the 17<sup>th</sup> and 18<sup>th</sup> centuries to the economic sphere, whose philosophers proposed limiting the powers of the State and protecting the “natural rights” of individuals, especially their civil, religious and political liberties as well as the right to private property, against abuses from monarchic absolutism<sup>1</sup>. Never denying the legacy which it absorbed from political philosophy, classical economic liberalism intended to be more than a purely economic doctrine, posing itself as a generating system of wealth and common good.

According to the principle of market “invisible hand”, as formulated by A. Smith and further developed later by authors of the marginalist and neoclassical schools (as the “market optimum” theory), each man, while rationally pursuing his own interests in the economical relations of buying and selling goods and services, and seeking the best proportion of cost-benefit in a system of free prices within a regime of perfect competition, satisfies the general interest while contributing to generate global increases in the overall economy's productive efficiency (reduction in production costs) as well as in its allocative efficiency (fulfilment of affordable demand). Consequently, the primary economic function of the State would be to guarantee and promote competition in the market, which would function as an ideal mechanism in regulating prices and the quality of goods and services, without interfering in the decisions of producers and consumers (as in the expressions *laissez-faire*, *laissez passer*, which popularized the

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<sup>1</sup> As well known, John Locke (1632-1704) was the precursor of political liberalism and the jusnaturalist doctrine, which expanded through the 18<sup>th</sup> century with “enlightenment” thinkers as Rosseau, Voltaire and Diderot, among many others.

economic liberalism of the 19<sup>th</sup> century). Liberal economists also supported freedom of external commerce against any kind of protectionism of national markets. Sustained on the theory of comparative advantages, free external commerce would lead to the mutual development of nations and lead to outcomes in political and strategic fields, as it would conduct nations to mutual cooperation among themselves in a peaceful and democratic manner.

Nevertheless, to the classics of political economy, aside from promoting free competition, the State would possess other fundamental political and economic functions: to maintain a judiciary system which would guarantee the accomplishment of contracts and legitimate the right to property; to guarantee national security and public safety through the armed and police forces; and execute or hire public works and services related to State institutions or common use resources and public spaces, such as the construction and maintenance of prisons or facilities for the functioning of the public authority, the building of bridges and ports or the lighting of public places. While the latter are more directly related to economic functions having to do with the provision of *public goods* (which do not attract the interest of the private sector due to structural reasons, as we will see ahead), the first refer to the guarantee of the *objective conditions* of liberty which only the State can and must provide once it legally detains the power to use force in order to inhibit or punish citizens who, acting against reason, obliterate other's liberties.

Though recognizing that the provision of public utilities linked to works and institutions of collective interest by the State generates benefits to society, as a whole, Adam Smith proposes that state intervention in this domain ought to pre-eminently tend to the needs of the market, relegating the general needs of society to a secondary role.

The market economy model, associated to the democratic State of right as proposed by classical economic liberalism, also presupposes specific *subjective conditions*, such as the utilitarian or instrumental rationality of the *homo economicus*, whose supposed universality has no broader anthropological or sociological foundation in the history of mankind, but stems from the capitalist social order at the same time it contributes to its formation, development and expansion.

## Neoclassical Economics Approach

The so-called neoclassical school, whose great father is Alfred Marshall (1842 – 1924), sought to refine and synthesize the postulates of classical political economy and those of the marginalist school, articulating the notions of productive and allocative efficiency of the competitive market as an organic whole. They also theorized on welfare economics in which the State would have the prominent role of providing *public utilities* and correcting *market failures*. Considering the distinction between private wealth and public or collective wealth, established by Marshall, economists such as A. C. Pigou and Paul Samuelson developed the analysis of those categories which would justify the direct or indirect intervention of the State in certain sectors of economic activity.

According to the neoclassical approach, public goods and utilities are those which generate collective benefits to society as opposed to private benefits derived from private goods and services. Their essential characteristic is the fact that the State is responsible for supplying its offer, directly or indirectly, through “delegated management”, under different contractual assortments or juridical regimes. The state responsibility is justified through several reasons such as: i) the low allure of these activities for the private sector once the investment cost is considerably high and involves the immobilization of considerable amounts of resources over long periods before yielding any profit; its low internal profitability, and the high risks involved; ii) the recognized social essentiality or utility of these services; and still iii) the connection of these to primordial functions of the State such as maintaining public order and national sovereignty, territorial planning and the redistribution of revenues to reduce social inequalities.

According to the welfare economics developed from Marshall, *public goods* (services inclusive) are distinguished from *private goods* through several characteristics. Public goods follow the “principle of universality” (non exclusiveness), according to which its users can not be kept from consuming them (free access), as well as to the “principle of non rivalry”, which is when the consumption of one user does not reduce the stock available to the others. So they are classified as *non-rival* and *non-excluding*

goods. Private goods, on the other hand, are *rival* and *excluding*, following the principles of individuality and exclusiveness. Due to the characteristics mentioned, a competitive market would not be formed for the supply of public goods, which would tend to be under-produced if not at all by the private sector<sup>2</sup>.

In order to complement the notion of public goods, economists such as Pigou and Samuelson (among others) elaborated the theory of the *market failures*, which would justify state intervention in providing certain services which would be set aside or inadequately supplied by the private sector. Basically, the theory identifies six situations of market failures which hinder the participation of the private sector, but favors direct or indirect state intervention, in determined activities, among which we find urban services and public utilities: i) the presence of significantly *decreasing costs*; ii) the existence of *natural monopolies*; iii) the evidence of considerable *externalities* or *external costs*; iv) the *impossibility of payment by the users* or v) the *impracticability of excluding non payers* or "free riders"; and vi) social and political concerns regarding *merit goods*.

The decreasing costs involve the so called scale economies, which enable significant reduction of the unitary cost of products and services when the installed capacity achieves a huge scope: this is the case of most of the public utilities. Their facilities have long durability which permits reducing unitary costs proportionately to increases in circulating capital (raw materials and other productive inputs) and variable capital (labor), maintaining relatively constant fixed capital (facilities, machinery and equipment).

The "natural" monopoly (or oligopoly) is related to an exacerbated situation of decreasing costs, in which the market does not support a large number of companies

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<sup>2</sup>Economic theory also distinguishes other sorts of goods, as *common property goods*, which are non excluding, but rival (e.g.: groundwater stocks); and *club goods* which are non rivals, but excluding (as toll-roads). Some authors distinguish yet the *free goods*, as a special sort of public goods which, being either non excluding and non rival, remain strongly refractory to public property or state dominance, as the air we breath and the sunlight. But it doesn't mean that public colectivities cannot assume full responsibility to care for those goods which constitute colective patrimony of its citizens, of nations or even humanity itself, by means of local or national regulations, or international agreemnets, as restrictions to automobile circulation in determined places or periods of time, to control great urban centre's atmospheric pollution, or the Kyoto protocol to detain the greenhouse effect.

operating at efficient scale or scope. In Sharkey's definition (*apud* Farina, Azevedo and Picchetti, 1997:49), "a monopoly is considered natural when the number of companies which minimizes the total cost of the industry is 1 (one)." In these cases, if the market is not contestable, due to legal restrictions or regulations regarding competitive tendering and the duration of the business, and if there are entry barriers to other operators, the theory foresees productive and allocative inefficiencies. In other words, it will result in high tariffs and insufficient expansion of services due to the absence of incentives to reduce costs or to seek innovations that stems from the power of monopoly which permits the application of prices higher than those of the marginal cost to a predominantly captive and inelastic demand (Mello, 2000; Rezende & Paula, 1997).

The question of externalities refers to "external costs" which impact those not directly involved in the relation between producers and consumers of a certain good or service, such as atmospheric pollution and traffic jams brought about by the intensive use of private automobiles in major cities, or surface water pollution stemming from the casting of domestic and industrial effluents associated to precarious sanitation services. The existence of (negative) externalities in the production and consumption of goods and services produces allocative inefficiency: as individuals and companies are not liable for the cost of these externalities, they tend to excessively engage in activities which generate these; since part of this production cost is externalized or socialized, the private cost is inferior to the social cost of production of the good or utility at hand. This situation encourages private agents to persist in generating these negative externalities, hence Pigou's proposal (1948) of internalizing external costs, especially those associated to environment degradation, through the implementation, via enactment, of the *polluter payer principle*, which encourages its reduction.

One must still consider the existence of "positive externalities" which refer to "external benefits" appropriated by parties not directly involved in the buying and selling of goods and services, such as the valuation of idle pieces of land caused by the installation of equipment and urban infrastructure utilities, or the reduction in expenditures with health and medical assistance derived from the supply of treated drinking water. In this case, on the contrary, it would be the governments business to socialize and restrain private appropriation of public or collective benefits through taxes

such as “improvement contributions”, which charges real estate owners whose properties benefit from public investments.

The impossibility of payment by the users and consumers consists in a market failure which involves two distinct situations. The first refers to low revenue populations which can not afford the full costs of certain services (i.e. telephone or public transportation) without significantly impacting their income, since they are sub-employed, unemployed or retired on a low income plan. Such groups should be eligible for exemption or direct (*vouchers*) or indirect subsidies (“social” or progressive tariffs with cross subsidies benefiting the small residential consumer), which can be covered by the operator as a general cost of the services, or by employee and employer contributions, or by public authority through budgetary allocations that will not burden services<sup>3</sup>. The second situation of impossibility of payment by the users is related to the indivisibility of the offer which characterizes certain services such as public lighting and roads, urban drainage or cleaning, since its consumption can not be divided or measured so as to individualize the charges to recover the costs. These are usually financed by taxes. The impracticability of excluding non payers or *free riders* is a variable of this last problem which basically impacts the same sectors.

Finally, the merit goods are those whose supply or consumption, although enhancing the life quality of individuals and promoting collective welfare, as generating positive externalities, are not usually the target of individual consumer preference. Pertain to this category goods and services related to education and culture, health services, public safety and national defense (armed forces) which supply should be guaranteed and tutored by the State through mandatory budgetary allocations bonded to tax collection, fiscal incentives (i.e.: tax deductible health and education expenses) or duties imposed upon citizens (i.e: conscription).

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<sup>3</sup> The concession of *vouchers* to well targeted populations is seen by Roth (1987) as the best solution to the insolvency problem. In Brazil, both kinds of subsidies are found on urban collective transport. the school pass, destined to students, which charges directly buses enterprises; the exemptions touching aged people and some public workers in service, as postmen and policemen (idem); and still the transport- voucher (“vale transporte”), which is financed by employers and employees’ contributions. Finally, cross subsidies, largely used in water and sewage services, were partially eliminated from the electricity and telephony sectors to facilitate their privatisation.

Nevertheless, identifying market failures in certain sectors of activity, does not necessarily imply that the provision of goods and services involved should be transferred to state, as intended by the majority of the authors from the neoclassical school, since this would mean confronting them with government failures associated to state provision, as the neoliberal economists later did (see below). Moreover, the characteristics of these services or sectors may change according to technological or political-institutional evolution of societies, like that occurring in the telecommunications and electricity field, which have lost a great part of their previous condition as natural monopolies over the last decades. Thus, realizing an empirical analysis of the market failures in several sectors, including public utilities and services, under the neoclassical paradigm, Roth (1987) suggests that governmental intervention must assume variable formats, according to failures or deficiencies observed in the specific market: taxation, regulation, private provision with subsidies, or even public provision. In any case, it is suggested that developing countries shall seek alternatives to increase private sector involvement on public services provision, considering market as well as government failures that are specific to each sector.

Though positioning itself in a perspective which is favourable to market economy, valuing the role of private property and enterprise as institutions which generate economic efficiency, the arguments of the neoclassical school in favor of social welfare attribute to the State the function of correcting social inequalities generated by asymmetric growth of private wealth as well as market failures, through direct or indirect state provision of public goods and services which are part of social and collective wealth. This perspective surpasses the individualism contained in the classic liberal school, without embracing the socialist ideal of distributive equality (economically inefficient). On the contrary, from Marshall to Pigou, the neoclassical authors limited the concept of collective solidarity and redistributive mechanisms involved in state intervention over economic activity to the principle of *equity*, according to which it would be the business of the State to guarantee the “basic needs” and “equality of opportunities” among citizens, whose capacities, motivations and

interests are knowingly unequal<sup>4</sup>. Some of the arguments of this school, however, indirectly contributed to broadening the frontiers of state intervention and legitimating the notion of social rights during the first half of the 20<sup>th</sup> century, giving way to the development of Keynesian ideas and policies which culminated in the formation and development of the Welfare State in industrialized capitalist countries following the end of 2<sup>nd</sup> World War.

### **Keynes and Keynesian approaches**

Having been Marshall's student in Cambridge, John M. Keynes published his most important work, *The General Theory of Employment, Interest and Money*, in 1936, when the United States as well as all the major European economies went through a period of stiff depression and unemployment as a result of the New York stock market crash in 1929. In his vision, this situation was a consequence of a structural sub-balance in economy, caused by the insufficiency of aggregated demand, generating a slope in economic activity and "involuntary unemployment" which could not be recovered by the market's regulating mechanisms alone. Upon demonstrating that the global levels of consumption and public and private investment would directly impact the level of income and employment in economy, Keynes proposed measures such as an increase in public investment, interest rate reduction and redistributive mechanisms which would favor the less affluent classes and stimulate consumption.

Upon demonstrating the incapacity of the neoclassical theory of market's optimal equilibrium to deal with permanent high unemployment rates, Keynes produces a theoretic "revolution" which was not restrained to the realm of ideas. Having been put into practice initially in the United States, during Franklin Roosevelt's *New Deal* program, Keynes' proposals became the dominant orientation of the economic policies in industrialized countries between the end of 2<sup>nd</sup> World War and the mid 70's, when the Welfare State was shaped and developed.

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<sup>4</sup> In his famous *Principles of Economics*, firstly published in 1890, Marshall identified as basic needs for a modest english worker or peasant the access to housing, food, primary education and time for leisure.

Despite this, the relation between Keynesianism and the Welfare State is not immediate or linear, once Keynesianism is not necessarily committed to public investment on urban infrastructure and social services related to the reproduction of labor force, while the latter assumes a strong commitment to the widening of state investment in these areas. With the intention of stimulating a muted demand and increasing the employment rate, income and global consumption of the economy, Keynes proposed a boost in public investment in general, which could be indifferently directed towards social services or military expenditures, among others. Conversely, the establishment and development of the Welfare State did not correspond to a systemic need of capitalistic accumulation, rather resulting from a long process of political, economic and social reconstruction of the industrialized capitalist nations begun shortly after 2<sup>nd</sup> World War. In this scenario, marked by European reconstruction under the Marshall plan and by the advent of the cold war, specific class relations appeared, involving long lasting political and social commitments between the major industry, powerful unions and willing governments with full employment and income redistribution through public investment containing social character and “indirect salaries”, within a context of economic growth thrust by the mass production of consumer durables (Fordism). Nevertheless, despite its differentiation in terms of origin or purposes, Keynesian policies and the Welfare State converge regarding the need or macroeconomic functionality of promoting the increase of employment rate and the socialization of consumption<sup>5</sup>.

However, the Welfare State developed beyond that predicted by Keynes who was conscious of the political and economic limits which arise from constant and lasting expansion of public expenditures which, in the long run, would generate high levels of inflation and a slope in economic productivity. These and other vulnerable aspects of the “Keynesian equation” and of the Welfare State were harshly criticized by the so called neoliberal economists.

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<sup>5</sup>For a deeper discussion about the keynesian Welfare State, which associates it to fordism, under the perspective of the French School of Regulation, see Harvey (1989).

In contrast to the neoclassical authors, Keynes did not create conceptual instruments which allows to analyse the specific roles to be carried out by the State or the market in providing certain goods and public services, especially utilities. But he decisively contributed to legitimating the role of public investment in macroeconomic equilibrium, indirectly promoting the development of state intervention in these sectors under the Welfare State.

### **Neoliberal Economics approach**

Inspired by classical economic liberalism, the neoliberal economists – among these Friedrich Hayek, Milton Friedman and James M. Buchanan, all of which bestowed with a Nobel prize – revisit and deepen the conception of a free market (based on competition between producers, suppliers and rational consumers of goods and services) as an optimal mechanism for promoting productive and allocative efficiency in economy, severely criticising the expansion of economical intervention by the state which characterised the Keynesian Welfare State in industrialised countries between the end of 2<sup>nd</sup> World War and the mid 70's, as well as the Developmentalist State of what used to be called the Third World, especially in Latin America.

Hayek is a pioneer in this line of thought, as he published "*The Way to Servitude*" a classical reading of economic neoliberalism in 1944, when Keynesian politics and the Welfare State were at peak. Besides this, he acted in favour of the neoliberal cause upon creating the Mont Pèlerin Society in 1947, which gathered some economists, philosophers and writers, such as Milton Friedman and Karl Popper, among others, to debate ways of opposing the increasing state intervention in economy and the consequent rise in tributes which tag behind the formation of the Welfare State.

Hayek as well as Friedman – author of the renown work "*Capitalism and Freedom*" (1962) and main exponent of the monetarist school of Chicago – associate market to liberty, and the state to coercion, defending the "minimum state", whose functions would be limited to: i) assuring liberty and justice to individuals and groups, including abundance to contractual rights and duties; ii) guaranteeing external security to the nation and public safety to all citizens. Though admitting that public investment can in fact generate macro-economic benefits in cyclical recessive moments, to both, the

long term tendency to an increase in regulation and direct intervention of the State over economic activity would mean a progressive increase in the tributary burden, an increment in public deficit, a rise in inflation and economical deceleration or even stagnation. In order to combat this tendency, which was in fact verified, to a greater or lesser extent, in the form of a fiscal crisis which struck most of the capitalist countries in the mid 70's<sup>6</sup>, neoliberal economists acclaimed the deregulation of economy and the labour market; the liberalisation of external commerce and the financial market; the privatisation of state enterprises and public services; the elimination of subsidies, a reduction of taxes and state expenditures (especially those related to social security); public deficit control and monetary austerity.

The mid 70's crisis was diagnosed as having been a product of the excessive authority of the unions, which systematically pressed for growing social expenditures by the State and for an increase in taxation over private capital, thus generating an increase in public deficit, inflation and small growth rate; consequently, the proposed remedy clearly shifted to the neoliberal prescription. Thus a hegemony of neoliberal ideas was initiated and was politically organised in the 80's, with the neoconservative administrations of Reagan, in the United States and especially that of Margaret Thatcher in the UK, which magnified neoliberal propositions through an active policy in combating union power through reforms in union and labour legislation, generating what is known as a "flexibilisation" of markets and work contracts, and renunciation of the ideal of full employment<sup>7</sup>. The relative economical and political success of these administrations in their time, their influence on multilateral organisations and the fiscal crisis of the State contributed to extending the hegemony of neoliberal ideas to the end of the 90's, with the adoption of neoliberal policies by governments with different political horizons and ideological mindsets, in developed countries as well as in developing ones.

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<sup>6</sup> For a left-wing analysis of late capitalism's fiscal crisis, envisaged as well as a political and social crisis of the Welfare State's legitimacy, see O'Connor (1973), Habermas (1978) and Rosanvallon (1981).

<sup>7</sup> To Anderson (1995), Mrs. Thatcher's government has been not only the pioneer, but also the most purely aligned with the neoliberal movement, while Reagan's government, despite cutting taxes and welfare benefits, kept the keynesian approach by increasing public expenditures in the military field, still under the atmosphere of cold war.

Nevertheless, according to Anderson (1995), the eminence achieved by neoliberalism was more political and ideological than economical or social since, though aiming at trimming inflation, increasing profits in the private sector and monitoring union manoeuvres, reducing the frequency and duration of strikes, engendered a rise in unemployment, social inequities and social exclusion. On the other hand, economic growth remained below expectancy (especially in the European Community countries), financial speculation was fomented more than productive investments and the fiscal burden continued to swell, though at lower rates, due to an increase in expenses with unemployment and retirees (who sought to anticipate their retirement plans in order to guarantee their acquired rights).

As for industrial services, public utilities and urban infrastructure, neoliberal policies led to reforms which imposed deregulation and privatisation of these sectors with the elimination or at least “flexibilisation” of the previous state monopolies, and to the deverticalisation and decentralisation of management, along with subsidies elimination and liberalisation of tariff policies. Meanwhile, for developing countries, the general results, though varying from country to country and sector to sector, can be *roughly* characterised as: i) an increase in direct external investment dealing more with capital transference to and sharehold acquisition by foreign enterprises than with investments to increase productive capacity or to improve the quality of private services; ii) rise in the tariffs for these services; iii) fall of investment levels in lower pay back areas, due to a lack of private interest and disavowal of the State; iv) incipient configuration of legislation and specialised organs for regulating each sector.

The (apparently declining) hegemony of neoliberal economic thought at the end of the 20<sup>th</sup> century, actively promoted by multilateral co-operation organisations<sup>8</sup>, was favoured not only by the collapse of the socialism of the soviet type and the fiscal crisis of advanced capitalist countries, but also by technological and managerial changes associated with the globalised post-industrial economy of the information era<sup>9</sup>. In this

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<sup>8</sup> Cf. the expression “Washington’s Consent”.

<sup>9</sup> For a deeper analysis of new information technologies’ impacts on the economy of post-industrial society, see Castells (2000, vol. 1) and Harvey’s (1989) analysis of “post-fordism”

era, the representation of economy as depending on demand, typical of the Fordist-Keynesian period, tends to be substituted by another: that of the *economy of competitive offer*, in which the role of the State is to attract direct foreign investment and promote flexible accumulation within the private sector, through a reduction in the general costs of economy and the establishment of a stable regulatory environment, capable of promoting productivity and innovations.

In this context, the specific theoretical contribution of the neoliberals towards the analysis of the market and the State respective roles in the provision and management of industrial and public utilities services, was to bring into the debate the consideration of "**government failures**", which generate specific productive and allocative inefficiencies. These failures, which can make state provision of the same services less advantageous than private supply, encompass the following situations (among others): the permanence of a affordable demand which would not be tended to in certain sectors where there is a delay or lack of public investment, for not being among the governmental priorities (a typical example is the telecommunications services); the capture of public enterprises by corporate interests of bureaucrats, labourers and politicians, promoting overemployment or inadequate control over tariffs readjustment; distortions in the appropriation of costs or even a reverse income redistribution generated by subsidised tariffs; deficiency in regulation which is left mostly to the public operator itself; and, last but not least, the lack of incentives to reducing costs or to the implementation of innovations due to public monopoly.

Though they clearly positioned themselves in favour of the privatisation of state enterprises and public utilities, the neoliberal economists arguments indirectly contribute towards renewing the debate about state *or* private provision, whose central point has been more recently shifted to the question of regulating public and private monopolies or to the defence of competition in these sectors through the neo-institutionalist approach examined below.

### **Neo-Institutionalist Approaches**

Over the last decades, economists have given more attention to institutions and to the role they play in economical organisation. They mainly focus on the impact of property

right structures and *transaction costs* over the incentives which influence the behaviour of economic agents. Conversely to the first institutionalists, which surged against the neo-classical notions that the market spontaneously tends toward balance and that economic agents act according to an universal utilitarian rationality, aiming at maximising benefits and minimising costs, the so called New Institutional Economics is based on the fundamentals of neo-classical micro-economics. This chain of thought, which covers several authors and perspectives (some purely economical such as the so called “information economy”; others more sociological such as the theories of rational choice, of public choice and that of the principal-agent), seeks to deepen the neo-classical suppositions of the utilitarian rationale through the incorporation of neglected aspects of traditional neo-classical analysis, such as the institutional arrangements which involve contracts and property rights, which significantly affect the costs, risks and decisions of economic agents<sup>10</sup>.

Neo-institutionalists share the notion of *bounded rationality*, coined by Herbert Simon, which considers the relativism of agents (individuals and companies) capacity of acting rationally seeking the optimisation of their economic interests, due to the existing blanks or asymmetries of information or in the capacity of processing it among different agents. Though they consider it limited and contingent, the authors of this chain recognise that the utilitarian rationale is basically diffused through modern economic relations in such a way that the agents would tend to react in a predictable manner to determined incentive structures.

Neo-institutionalist approaches to economy supply a true arsenal of fertile concepts for the analysis of the regulation of public utility and industrial services, once they permit the construction of institutional models which could be adapted to the

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<sup>10</sup> The former Institutional Economics, which has in T. Veblen one of its precursors, appeared in the USA when great private oligopolies started to dominate the productive and financial spheres of north-american market. J. R. Commons e W. C. Mitchell, the main exponents of this school, opposed the idea that the free market, with fluctuating prices, could act by itself as an efficient mechanism for resources allocation, capable of generating equilibrium in economical relations. Conversely, they recognized the existence of unbalances inherent to the markets' operation, as well as a broad shock of economic interests econômicos between different social groups, which should be conciliated by governments by means of democratic reforms, social policies and state intervention on planning and regulation of determined activities or sectors. On the contrary, the New Institutional Economics, shall not be considered as opposed or concurrent to neoclassical economics, but rather as a complement of this latter (Kemper, 1996: 32).

peculiarities not only of each sector, but also of the political and cultural environment of each country. Below we examine some of the main concepts extracted from this literature, beginning with the broadest and most fundamental one: the notion of “transaction costs”.

The notion of transaction costs was introduced to economic theory by R. H. Coase in his famous article “The nature of the Firm” dated 1937, in which he explains the origin of the private enterprise in the need to minimise costs implicated in negotiations, hiring, supervision and execution of contracts with raw material and labour suppliers. If producers were to purchase raw materials, hire personnel and control the quality of production daily, the “transaction costs” involved in the production of merchandise would be extraordinarily high regarding financial costs as well as time and the risks involved. Upon organising production in the form of enterprises, producers significantly slash these costs which can be classified into different categories.

From a temporal aspect, we can distinguish between transaction costs *ex-ante* and *ex-post*. The first basically refer to the gathering of relevant information pertaining to the market; to negotiation of deals or contracts with service, raw materials and labour suppliers; as well as communication between the parts involved. The latter, on the other hand, involve monitoring the execution of contracts by participants, eventual renegotiations, besides costs regarding compliance with legal demands which discipline the activity at hand. From a more general standpoint, we can distinguish between transaction costs considered inevitable and those considered “strategic”, both being related to the gathering of trustworthy information in respect to the business. The “inevitable costs” involve the time and resources spent on negotiating, monitoring and executing the terms of any contractual business. The strategic costs, on the other hand, are not necessarily omnipresent in business, but rather result from situations in which *incomplete markets* are detected, more generally associated to *imperfect information* or *asymmetric information* in which an actor or group of actors tends to adopt an

opportunistic behaviour in order to maximise their own benefits in detriment to the other parts involved<sup>11</sup>.

The goods and services market which does not generate enough effective demand are considered incomplete, though they may be supplied at lower costs than the disposition of the customers to pay for these. The *asymmetries in information* – when the suppliers/sellers know more than the consumers/buyers or vice-versa – may cause distortion and/or uneasiness which might harm consumers and threaten the profit of determined markets. The problems of *adverse selection* and *moral hazard*, which are analysed by the “theory of incentives” or principal-agent, are particularly observed in the labour and insurance markets.

“Adverse selection” occurs when the purchasers of a given service tend to force their supplier to pay costs which are above average, or when the sellers are able to exclude high cost clients. A typical example can be found in the health insurance markets: “those who are more likely to need medical assistance are the ones who will most likely seek to acquire this type of service and will tend more likely to be refused by these insurance agents ( World Bank, 1997: 26).” The “moral risk” in turn, is present “when the insurance holder has an incentive to provoke or permit the situation which is the object of insurance to occur.” An example is the tendency that health insurance holders have to seek and that the providers have to offer “more treatment than necessary when liability for costs is to be covered by insurance agents” (idem, ibidem).

The problems of adverse selection, moral risk or even *rent seeking* are related to ***organisation failures*** in certain areas of activity which impact the private as well as the public sector<sup>12</sup>. Therefore, the solution for these questions can not be found in privatisation or public provision of these activities, but in the establishment of legal and

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<sup>11</sup> Williamson (1984), presents an excellent definition of the opportunistic behavior quoted by Kemper (1996:37): “...the opportunism refers to the revealing of incomplete or distorted information, mostly as calculated efforts to deceive, to disguise, to obscure or to confuse.”

<sup>12</sup> Raised under the “public choice theory”, the *rent seeking* concept describe a situation in which a clerk or director of public administration seek to obtain personal gains in terms of financial or material advantages, prestige and power in detriment of public interests. However, the rent seeking problem also exists within private enterprises, although we may suppose that it is easily controlled here than inside public administration, given the rigidity of administrative right rules.

economic regulating mechanisms, involving aspects known as *regulatory governance* and *regulatory incentives*. The first concept encompasses the mechanisms which society uses to restrain discretionary power in the regulatory activity and to solve conflicts resulting from regulatory exercise. The second involves pricing rules, cross or direct subsidies, tender rules, entry fees, etc.. The institutional lay out and incentive schemes should adapt to specific characteristics of the sector at hand and to the “regulatory environment” in which it is inserted, which is defined by contractual information restrictions and political-administrative ones as well (Farina, Azevedo and Picchetti, 1997:58).

In the case of utilities, the most relevant question pertaining to regulatory environment and governance pays respect to the minimisation of the *political hazard* associated to a few essential characteristics of the sector, as follows: the *sunk costs* connected to infrastructure and the generalised and price-inelastic consumption of related services. The *sunk costs* involve the presence of non-recoverable assets linked to locational specificities<sup>13</sup>, while generalized and inelastic price consumption have been associated (not always properly, as we see below) to the *essentiality* of the service and the captivity of its demand. Under these conditions, private enterprises which rely on the exploration of such specific and irrecoverable assets in order to obtain income or return on their investments are subject to the risk of interruption in incoming payments if public authority might decide to expropriate these assets, tending to populist (or not) expectations of users/voters. In absence of gaining return guarantees, investment on utilities will not be assumed by the private sector or will be made at levels underneath social expectations. So, in order to be successful, a model of utilities management in which private enterprises will be charged of services provision needs to offer operators some sort of guarantee against the expropriation of irrecoverable assets (i.e.: of gaining return), which depends on the stability of the pertaining legislation and the credibility of the government ( Farina, Azevedo and Picchetti, 1997: 60-62).

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<sup>13</sup> For instance, the owner or the operator of water and electricity networks cannot leave a non profitable market and carry with him the assets to provide services elsewhere. But there are other kinds of investment irreversibility related to infrastructure not directly linked to locational specificities, but rather to the required large

However, we must consider that such arguments may be biased by a neoliberal approach, as they are focused exclusively on the stand point of private companies, not considering the user's point of view, which may vary considerably in different social contexts. For instance, the link between essentiality and price inelastic consumption of utilities services may not be so valid in developing countries as it may be the case in developed ones<sup>14</sup>. While in rich countries virtual universalization and social regulation may assure that basic consumption of public services is not affected by prices fluctuation, in developing ones low income populations pressed by a strong increase in tariffs may renounce to basic consumption of essential services, despite the risks it may cause to their own health, their life and the environment.

Anyway, social context is not absent from neo-institutional economics approach. On the contrary, considering the problems related to *path dependence* or *social capital*,<sup>15</sup> some authors related to this stream stressed that the adoption of exogenous regulatory models or the imitation of regulatory reforms which were successful in a given environment may give way to unsuccessful experiences. As Levy and Spiller observed: “[The] success of a regulatory system depends on how well it adapts to the existing institutions in a country. If a country does not present the necessary institutions or imposes an apparatus which is incompatible to its institutional environment, efforts towards privatisation may end in frustration, recrimination and in the rousing of demands for the reestablishment of public provision”<sup>16</sup>.

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capital immobilization on long during and technically rigid systems which are very expensive and unwieldy to update.

<sup>14</sup> In fact, sumptuary consumption of luxurious and rare services or goods (as high expert advice or art masterpieces) is the most inelastic to prices, much more than the consumption of essential goods and services.

<sup>15</sup> The *path dependence* concept refers to the idea that present technological or institutional choices are conditioned by the rooting level of technological or institutional choices made in the past. The *social capital* concept, in this context, refers to cultural valuating of informal rules rooted on agents' behaviour which shall be considered when trying to introduce changes. Both concepts help to explain why the same kind of institutional change or reform may bring distinguished or even opposed results in different social contexts.

<sup>16</sup> *apud* Farina, Azevedo and Picchetti (1997: 61).

We may conclude that the most relevant specific contribution of the New Institutional Economics to the debate regarding utilities privatisation and regulation, consists in elaborating positive theories of regulation which equally analyse the failures of market, government and organisation, seeking to define measures towards regulatory governance and appropriate regulatory incentives for specific political-institutional environments.

### **Economics and Politics of Social Regulation**

In the preceding items, a brief summary of concepts and approaches regarding the roles of the market and the state in the management and provision of public utilities services was made from the economic theory standpoint. What was shown was that the debate in this field, which in other times would have alternated between arguments for and against public or private provision, has shifted to the question of services regulation through juridical-institutional instruments. Though this shift may correspond to the theoretical and analytical enhancement of reflections regarding utilities management and regulation, the emphasis on micro and macro-economic aspects of the sector sets aside other aspects which are equally relevant, such as: the role of utilities as collective consumption means and support of productive activities in the reproduction of life and labour conditions of people, specially of jeopardised workers nowadays<sup>17</sup>, as well as the significant impact of these activities on the environment. Both aspects demand a broader approach which would surpass the perspective of *economic regulation*, predominantly appearing in today's debate regarding utilities privatisation and regulation, and would incorporate the elements of *social regulation*. Such perspective should seek to combine elements of analysis from normative and positive regulation theories, considering the regulatory environment of each country and the incentives structure (economic and social) which would be appropriate from country to country.

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<sup>17</sup> This question is discussed in depth Silva (2000).

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