

Service Performance Guarantees for Public Utilities and Beyond—An Innovation with Potential to Attract Investors to Emerging Markets

Emerging market countries require substantial foreign investment for development, economic growth, and poverty alleviation. There are multiple challenges to attracting this investment, however, ranging from political and economic instability to corruption, poor security, and small market size. An additional challenge is inadequate delivery of key services like electricity and other utilities that private firms and investors rely on. Service performance guarantees are a promising approach to addressing this issue. These guarantees enable firms to purchase protection against poor or insufficient service delivery, and they may work particularly well in industrial or export processing zones by ensuring that shortfalls in service delivery are measured, reported, and addressed in a timely manner.

For emerging markets, foreign direct investment (FDI) is critically important. Beyond providing much-needed capital, FDI contributes to productivity growth through managerial and technological knowledge transfer. Such benefits are most beneficial to countries with the lowest levels of capital accumulation and leveraging of technology.¹

Unfortunately, these countries face barriers to attracting FDI. These include the limitations of small markets, poor security, and macroeconomic and political instability. Some of these are entrenched and yield only to incremental improvements in the short term.² However, a large volume of economic literature suggests that there are other barriers that can be more readily addressed with changes in policy and the deployment of public resources. These include addressing low quality physical infrastructure, lack of financial sector development, and weak institutions.³

To help firms mitigate risks inherent in emerging economies, international financial institutions (IFIs) offer guarantee products such as political risk and credit guarantees. Trade finance guarantees have escalated in the aftermath of the 2008–09 global financial crisis, which saw the withdrawal of some prominent private insurers from emerging markets. On transactions that involve real estate

or infrastructure investments, other types of guarantees are common, including partial risk or credit guarantees, credit enhancements, surety bonds, or simply letters of credit.

A New Idea: Service Performance Guarantees

It is possible to extend available guarantee instruments to encompass a wider range of non-commercial risks, and to integrate guarantees more centrally into reform and investment programs supported by donors. Service performance guarantees, or SPGs, are contracts in select economic zones between zone hosts (including governments) and zone operators (manufacturers, traders, and other goods and services providers). Issued as bank or insurance type guarantees, SPGs allow private firms and investors to secure protection against poor service delivery by an economic zone's authority.

These guarantees trigger pay-outs when service delivery standards fall short of those expected or agreed to. SPGs may work particularly well within export processing zones or other defined industrial spaces, and especially in newly industrializing countries. Donors or other entities can provide a first-loss guarantee fund to back up the local authority that is providing the guarantee.

SPGs could help attract the large infrastructure investments badly needed in emerging markets. Their creation would accompany the broader political risk guarantees necessary to bring investors to infrastructure projects. In limited settings, SPGs may increase government accountability to investors, and by doing so increase the amount of investment and jobs created. For all these reasons, SPGs can be viewed as a first step toward persuading investors to enter an emerging market country.

The Relationship between Service Delivery and FDI

In emerging markets, the investment climate often leaves much to be desired. While countries differ in many ways, assessments of their business climates often note the limitations of small markets, poor security, and macroeconomic or policy instability. The assessments also typically flag the high costs and idiosyncratic risks that result from poorly functioning infrastructure, as well as institutions that provide services to business. Business climate assessments have diagnosed these problems over several years and provided objective measures of some problems, in addition to investors' subjective assessments of different barriers to their businesses.

More objective measures include the World Bank's *Doing Business* indicators and quantitative estimates of the high costs of unpredictable power outages and other challenges that reduce the profitability of firms.⁴ Subjective assessments often cite poor power supply, macroeconomic instability, and poorly functioning services, which in some cases are due to corruption.⁵

For foreign investors considering investing in a developing country, country risk stems not only from the possibility of expropriation of resources or arbitrary changes to the law.⁶ It also comes from unpredictable service delivery. Therefore, mitigating the risk of poor quality service from public utilities and bureaucracies could help emerging markets attract more FDI. Doing so requires that improvements in service delivery be funded and realized. Equally important, however—especially in the short term—is the need to signal to investors that the government is committed to bringing about and sustaining these improvements.

Existing Guarantee Mechanisms

To reduce risk for investors, guarantees are currently offered by many bilateral and multilateral institutions, including the Multilateral Investment Guarantee Agency (MIGA), IFC, several regional multilateral development banks, the Overseas Private Investment Corporation, CDC

Group plc, Société de Promotion et de Participation pour la Coopération Economique, and many others. The fact that these organizations are bilateral or multilateral agencies may provide an additional source of comfort to investors since, as is the case with the multilateral agencies, the host country will generally be a shareholder of the institution providing the guarantee, which can be a powerful deterrent to government actions that may affect investments.

MIGA, the World Bank (IBRD/IDA), and IFC offer different types of guarantee products. For example, non-commercial risks that MIGA covers under its political risk insurance include breach of contract, war and civil disturbance, currency convertibility and transfer restrictions, and expropriation. The variety of coverages may be offered across a variety of projects, including public-private partnerships for infrastructure investment, subject to certain eligibility requirements.⁷

MIGA's guarantee is a very effective instrument to manage and mitigate non-commercial risks, which are inherent in agreements with government parties. Two examples of non-commercial risks that MIGA may cover under its political risk insurance product are:

- **Breach of Contract:** *Protects against losses arising from the government's breach or repudiation of a contract with the investor (for example a concession or a power purchase agreement).*
- **Non-Honoring of Sovereign Financial Obligations:** *Protects against losses resulting from a failure of a sovereign, sub-sovereign, or state-owned enterprise to make a payment when due under an unconditional and irrevocable financial payment obligation or guarantee related to an eligible investment.*⁸

MIGA's insurance products can be used in a broad range of sectors, including infrastructure and service sectors, which involve long-dated assets, government off-take risk, and local currency revenues. However, the data suggest that manufacturing and agriculture projects, which are in the key job creation sectors in low-income countries, are not the major direct clients for such guarantees, but show significant growth potential.⁹

Political risk guarantees may cover a standard set of risks that typically include non-commercial risks such as currency inconvertibility and transfer restriction, expropriation, war, terrorism and civil disturbance, and breach of contract.

Service performance guarantees could expand the suite of guarantee products offered by the WBG by covering risks

that existing guarantee products don't cover; they could be made available for certain investment structures that are currently not eligible for coverage under existing products; or they could supplement existing products by helping expand the scope of coverage through loss sharing mechanisms.

Surety Bonds as a product providing a performance guarantee for Local Enterprises

One product line providing a kind of performance guarantee is the surety bond. Such bonds remain strongly underutilized in emerging markets, with the exception of those with strong ties to markets where surety bonds have a long tradition (for example, the United States, Germany, and France). Surety bonds are used in emerging markets such as Mexico, Brazil, and Colombia, but are less prevalent in Africa and Asia (other than China) or where certain market conditions linked to exports prevail (such as South Korea). However, the companies offering such products are keen to expand their activities to new markets.¹⁰

Surety bonds are a tripartite agreement between the operator of a work or project, the sponsor or ultimate beneficiary of that work or project, and a financial institution (a bank or insurance company) that guarantees completion of the work or project.

Surety bonds provide financial protection, either through an insurance policy or an on-demand Letter-of-Credit issued by a bank. Both are available to the sponsor of a work or project—often a construction, concession, infrastructure, or energy/water supply project—and provide access to funds in the event of a breach of the work/delivery contract, concurrent with a default of the operator. Both guarantees are issued for a similar purpose, but insurance companies' additional value is that a) their bonds do not affect the credit limit of the operator, and b) insurers tend to 'step into the shoes' of the operator with the goal of completing the work or project rather than just providing funds. Surety bonds can be required for competitive bids, construction contracts, latent legal obligations (such as taxes), or anticipated future revenues (for airport concessions or toll roads).

For example, most municipalities and government agencies require construction bonds on public works projects, giving them financial recourse if the contractor is unable to finish the work for financial and technical reasons. Workers may benefit from a payment bond that guarantees subcontractors and other workers get paid if the contractor defaults. Again, under long-duration concession contracts (such as toll roads) government agencies will be assured that their expected

revenue will materialize. A judicial bond will be issued to cover a tax obligation that is claimed by tax authorities but is disputed by the concession holder. These are a few situations where surety bonds provide sustained assurance that contractual obligations will be honored. Unfortunately, use and application of surety bonds in emerging markets is still very limited. And whenever surety bonds are required (typically on large contracts where the beneficiary is a government agency or a large non-government organization), small and medium-size construction firms tend to be unable to access the product. Such firms typically lack the expertise, quality of documentation, and financial strength to qualify for the necessary bond, even if the local insurance market offers the product.

How can Surety Bonds be Used in Emerging Markets?

Surety bonds, especially when issued by insurers, can play a useful role in emerging markets, as they can free-up credit and capital that is currently used to provide the necessary guarantees. Also, they allow banks to focus on lending for operational work (such as materials and salaries), rather than on contractual guarantees. Developing local surety bond platforms could also increase liquidity in the construction sector and enable local contractors to participate in major infrastructure projects. This, in turn, could boost employment, as contractors hire local workers, supervisors, architects, and engineers. It could also drive the growth and formalization of businesses. As small, informal contractors grow larger, they become formal, registered businesses. And already-formal firms could be able to bid on large projects. This could be greater employment of young people, a significant challenge in many countries in Sub-Saharan Africa, the Caribbean, and the Middle East.

Possible Providers of SPGs: Investment Zones

Just as hotels or shopping centers must compete for clients, countries must compete for investors, especially when their industries are not closely tied to a strong natural resource base. Countries, or more likely investment zones within them, can thus be thought of as 'investor hotels' (or hosts). And they may have better negotiating positions in terms of leverage or purchasing power than is the case with individuals.

Some countries have particular assets such as attractive location, low-wage labor, or natural resources. But these may not be enough to attract robust interest from a wide

range of investors, unless the country or economic zone is able to offer services (including security services) at minimum acceptable standards. Like shopping malls, countries may also try to attract and retain a few high-quality ‘anchor’ investors that can deliver externalities and enhance a country’s reputation. Costa Rica’s courting of Intel to gain the attention of other investors is an example.¹¹

Service performance guarantees can combine the different elements of service guarantees. Both domestic and foreign firms would be eligible for these programs and would be offered the opportunity by the government or the authority managing the economic zone to purchase a contract guaranteeing the delivery of specified services, at minimum standards and for a prescribed period. At the minimum, guarantees would have to be provided for 12 months. Most guarantors would be reluctant to commit to more than two to three years, though a longer period—possibly as long as 10 years—may be necessary to make it work.¹²

If offered within an economic zone, the contract could be embedded in the rental agreement for the premises or land. Drawing on the lessons above, contracts would be standardized rather than customized, except for those for the largest firms. Although a form of protection or risk-transfer, SPGs cannot be implemented on an individual basis, as is the case with political-risk and credit guarantees. The costs of SPGs would be prohibitive because they would need to insure large numbers of firms and provide payments to cover lapses in service performance that could be recurring and relatively small.

The guarantee could potentially cover a range of services. These could include, for example: the speed of processing of duty drawbacks and value added tax rebates as well as other formalities; inspections and permits; the time needed for port turn-around; and customs clearance at ports or airports for products made within a zone. Under certain conditions, it could be feasible to cover the quality and reliability of power supply provided by the zone authority. The guarantees would be contractual, legal agreements between the service provider—likely the operator of the zone—and the firm.

The SPG contracts would be covered by a ‘domestic reserve’ or pool funded from contributions paid by the firms. This reserve could be part of the lease agreements. The reserve or pool could also be backed by a further guarantee issued by an agency such as the United States Agency for International Development’s Development Credit Authority, which already has authority to issue guarantees to domestic as well as foreign investors. This would be a more efficient

use of funds than a direct grant or subsidy, as the guarantee would be conditional upon the occurrence of a specific set of events. To cover the backup guarantee, an ‘external reserve’ would be set aside out of the loan amounts.

Payouts on the performance contracts that exceeded the domestic reserve of the SPG would trigger calls on the external reserve as well as a payment from the development agency to cover the balance of the SPG. At the end of the prescribed period, any unused balances in the domestic and external reserve funds could revert to the country as a performance bonus for providing high quality services.

Many design considerations relating to the structure of the domestic reserve will be specifiable only in particular contexts. For example, it is not possible to decide in advance for all contexts whether the fund should be an accounting-level designation, a virtual fund (making the money paid in as contributions available to fund service improvements), or an actual ring-fenced pool of money unavailable for spending.

Making SPGs operational

The SPG approach aims to strengthen incentives for delivering results. At the same time, however, it aims to provide firms with protection against inadequate delivery of key services, and to ensure that shortfalls in delivery are measured, reported, and conveyed to a high political level.

Implementing an SPG begins with understanding the biggest impediments to investment. Some of these impediments, such as macroeconomic instability, might be out of range for consideration. Others, especially in the area of public services, could be within the scope of a potential project, and thus benchmarked against international norms. Projects may already be addressing these areas, and these could be pulled together under an umbrella private-sector development program that would aim for an agreed set of performance standards, together with systems for monitoring performance. Within a particular economic zone that already has a management structure, it might be more practical to pull the service standards together.

In the first instance, firms within a zone would be offered the opportunity to purchase a contract that provided protection against service lapses. To avoid an incentive for providers to prioritize certain firms, it might be better to insure against zone-wide performance, rather than insure for the services provided to individual firms. This could simplify monitoring and reporting.

Compensation to a firm could be subject to two ceilings—one related to the level of protection purchased, and the other to the volume of investment, sales, or exports. This is to ensure that firms are not able to profit by betting on the performance of the economic zone operator. It is also necessary to ensure that the reserve fund can cover a suitably large number of firms. Compensation would be in recognition of poor service; it would not be practical to offer contracts that cover business losses. Payments under the program might be structured such that the absence of, or reduced access to, power for x days results in a payment of y . If climate events are included (wind, flood, drought), indexed triggers are likely to be more efficient.

Monitoring would be on a monthly basis, be part of the performance agreement between government and the ministry responsible for the project, and be reviewed by a tripartite commission representing government, investors, and the donor. Lapses in performance beyond specified levels would trigger automatic compensatory payments to the covered firms. If firms were in a special economic zone, payments could initially be in the form of rebates on rents and other service charges. Depending on the contract, extremely poor service delivery could cause payments to exceed fees, which would require access to reserve fund. The total liability of that fund would need to be capped at some level, with a limit set on the term of the guarantee program (10 years, for example). The resources for the reserve fund would come out of the allocation of assistance to the country, perhaps as a supplement to the business development funding.

Could SPGs actually work? Benefits and risks

As a complement to an ongoing infrastructure investment program, the proposed guarantee program offers several potential benefits. First, it would add credibility to the infrastructure program and serve as a marketing tool for the country. Without ‘picking winners’ it could play a role in encouraging investors, especially investors in export-oriented activities. Second, by emphasizing service delivery results, it could provide a framework for investment and for building capacity, with a focus on setting standards and monitoring results. Third, and perhaps most important, it could escalate policy dialogue and reform in the country’s investment climate. Serious performance lapses would be treated as a breach of contract. The approach would restructure accountability, placing it on the country’s authorities and the multilateral and bilateral donors that support the program.¹³

Examples of service guarantees can be found around the world. Firms located within some export processing

zones in China are guaranteed call-backs within a fixed period to address their concerns. Ships passing through the Panama Canal are guaranteed certain types of benefits from the Canal Authority, while firms within the Subic Bay Freeport Zone in the Philippines also enjoy various types of guarantees by the zone authority. In several states in Australia, both businesses and households are automatically compensated for loss of power by the utility provider. PacifiCorp in the United States compensates customers for power losses according to a predetermined guarantee structure. And in many countries, authorities that manage malls offer service guarantees (power, security, cleanliness) to the merchants located within them.

Of course, the difficulties and risks also need to be considered. The first of these is over-complexity. The approach outlined above will only work if the performance contracts are reasonably simple and easy to monitor. It might be easiest to pilot them in enclaves, particularly in industrial zones, where infrastructure and enabling conditions (for example one-stop shops) are in place for service delivery. In this kind of setting, the zone operator is typically already offering a package of infrastructure, public services, and streamlined regulation. A service performance guarantee can more easily be added to such a package. The World Bank currently has several projects that support such zones, and these may provide an entry point.

Credible and independent monitoring of the service indicators is essential, as is their transparent publication. New technology is increasingly being used by firms in service sectors to increase efficiency, including monitoring the timeliness of service delivery on a real-time basis. For example, India’s huge Aadhaar program, which provides unique identity numbers for the country’s residents, collects real-time data on individual enrolments that can pinpoint error-prone operators or defective equipment. With some 50,000 enrolment stations, that program has already enrolled over 600 million people. Technology continues to create new ways to monitor a wide range of services, including approvals, rebates, power supply, and transit.¹⁴

A second risk is that of severe losses due to inadequate implementation of reforms or overly optimistic projections of service standards. This raises two problems: first, limits to government capacity, and second, the span of control of the entity that is issuing the guarantee. SPGs will lack credibility if issued by governments with inadequate capacity, or in countries experiencing political instability. Thus, SPGs are probably not a useful instrument for fragile and conflict-affected states.

In addition, the operator of an economic zone cannot be expected to issue a guarantee covering the performance of a provider, such as a power company, that is outside the operator's range of influence or control. Either it will be necessary to severely constrain the scope of guarantees, or some arrangement will be needed to ensure joint responsibility for service delivery. A powerful coordination mechanism or steering group will be needed to bring together a zone's key service providers, which could possibly be done under the aegis of a country's president or another senior official. Such an arrangement could greatly benefit such projects, which experience shows can be impeded by special interests or lack of cooperation. The credibility of the issuer and the appropriate bundling of SPGs are both key to the success of the guarantees.

These considerations limit the number of countries in which SPGs might be feasible, as well as their scope (Figure 1). The approach is not practical in countries with poor or unstable governance, or those that have little credibility with investors. SPGs also may not prove attractive to countries that are already well-established with a broad span of investors. SPGs' greatest appeal will be in well-managed countries that seek to broaden investments to a wider range of sectors and those that want to diversify beyond the extractive sectors. The design of the operation also requires that the agency issuing the SPG has a span of control wide enough to manage the insured risks.

A third set of risks is exposure. This could exceed resources unless contracts are limited and service level standards are realistic, taking into account improvements expected from the project as well as the additional incentives provided by the SPG. Provisions are also needed to cover situations beyond the control of any service provider, such as conflict or severe natural disasters.

Only in truly extreme cases (for example, war or severe natural disasters) would the service standards be waived by arbitration. These are serious concerns because it is possible to imagine conditions under which SPGs would do harm rather than good. For example, suppose the agency issuing the guarantee has no authority to improve the performance of the services it covers, and the service standards are set at an overly optimistic level. Firms ill-suited to operating under poor service conditions could set up in the economic zone, or they could fail to take risk-mitigation measures. The adverse effects could be loss of productivity, the diversion of aid to firms, and a further loss in the country's credibility as a destination for private investment.

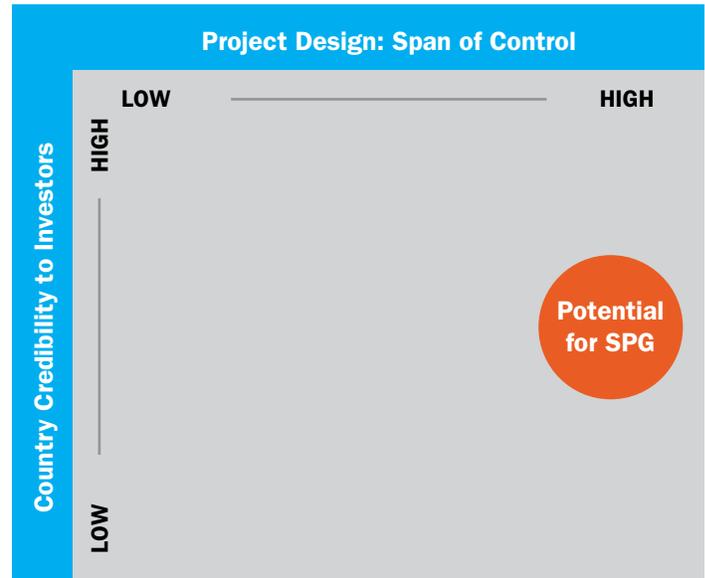


FIGURE 1 The potential space for a service performance guarantee

Source: Gelb et al. 2014.

A fourth risk is fundamental: Will firms come? Will SPGs convince firms to sign up in large numbers even if the SPGs do not cover business losses due to poor service? The response of firms will, of course, reflect the attractiveness of the conditions. But even if just a few firms enroll, some of the SPG's purposes will still be served. The guarantees will force the focus on standards and continuous performance monitoring. Shortfalls that trigger compensation out of the reserve fund supported by the donor will spur policy dialogue and even news events.

On their own, SPGs cannot substitute for the large investments in power, transport, and other infrastructure that may be needed to enable service standards to progress to the point where they are sufficiently developed to be included in an SPG. They also cannot substitute for the large political risk guarantees that are needed to attract investors to such projects.

Conclusion

Service performance guarantees can be seen as an extension of results-based aid. But they provide a different type of accountability—one that is a partnership of donors, recipient governments, and their investor clients. This contrasts with conventional results-based aid that makes disbursements to governments conditional on their achieving service outputs or outcomes, without a direct link to the clients using the services.

The design of SPGs can draw on a wide range of experience, including how shopping malls and hotels court their clients through service guarantees (as understood in the service sector), political risk guarantees, citizen charters, and right-to-service movements. While these are all very different, they all offer lessons that can be used to inform the design of SPGs, either as standalone instruments or, more likely, as components of productivity-related projects and programs that aim to increase private investment. More work is needed for the detailed design of such instruments before they can become operational.

ABOUT THE AUTHORS

Vijaya Ramachandran and Alan Gelb are Senior Fellows at the Center for Global Development, Washington, DC. (vramachandran@cgdev.org; agelb@cgdev.org)

Martin Reto Buehler, Principal Insurance Officer, Insurance and Financial Guarantees, Financial Institutions Group, IFC. (mbuehler@ifc.org)

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Additional EM Compass Notes on insurance solutions for attracting investments in emerging markets are:

Innovative Insurance to Manage Climate Risks (Note 9), *How New Data Tools Can Assess Climate Risks* (Note 10), *How Business Can Insure Against Climate Risks* (Note 11), *Insurance Options for Addressing Climate Change* (Note 13), *How To Make Infrastructure Climate Resilient* (Note 14); *Crowding-In Capital: How Insurance Companies Can Expand Access to Finance* (Note 52).

¹ It is important to note the differing ‘absorptive capacities’ of emerging markets, which result in differing levels of contribution of FDI to economic growth. This contribution is generally highest in the poorest countries. Alguacil, A, A. Cuadros, and V. Orts. 2010. “Inward FDI and growth: The role of macroeconomic and institutional environment.” *Journal of Policy Modelling*, 33 (3).

² Collier, Paul. 2013. “Aid as a catalyst for pioneer investment.” WIDER Working Paper No. 2013/00.

³ Kinda, Tidiane. 2010. “Investment Climate and FDI in Developing Countries: Firm-Level Evidence.” *World Development* 38 (4): 498–513.

⁴ World Bank. 2014. “Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises.” World Bank Group, Washington, DC.

⁵ Eifert, Benjamin, Alan Gelb, and Vijaya Ramachandran. 2008. “The Cost of Doing Business in Africa: Evidence from Enterprise Survey Data.” *World Development* 36 (9): 1531-1546.

⁶ Asiedu, Elizabeth, Yi Jin, and Nandwa Boaz. 2009. “Does foreign aid mitigate the adverse effect of expropriation risk on foreign direct investment?” *Journal of International Economics*. 78 (2) 268–275.

⁷ For an overview of available products see the World Bank Group’s PPPLRC Public-Private-Partnership Legal Resource Center: <https://ppp.worldbank.org/public-private-partnership/financing/risk-mitigation-mechanisms-products/guarantee-and-risk-insurance-ifis/guarantee-and-risk-i>.

⁸ MIGA. 2017. “Types of Coverage.” www.miga.org/investment-guarantees/overview/types-of-coverage.

⁹ Berne Union. 2017. “Strong Growth in New Business for BU members in 2017.” The Bulletin on International Trade, Finance and Investment from the Export Credit and Political Risk Insurance Industry.” Berne Union – Spring Meeting. <http://cdn.berneunion.org/assets/Images/6345be17-145a-4695-aaa1-44fa4980b71c.pdf>

¹⁰ 81% of total global surety premium volume of \$13 billion is written in advanced markets. Swiss Re. 2014. “Trade credit insurance & surety: taking stock after the financial crisis.”

¹¹ Larrain, Felipe, Luis Lopez-Calva, and Andres Rodriguez-Clare. 2000. “Intel: A Case Study of Foreign Direct Investment in Central America.” Working paper 58, CID, Harvard University, December.

¹² The pricing of service performance guarantees is worth exploring. One alternative would be to base the price on relevant quotes from commercial insurers. However, commercially-based SPGs are likely to be unattractive to potential investors; governments and/or donors will likely play a role in providing a subsidy or a backup guarantee.

¹³ In some instances, business continuity insurance may play a significant role. This is explored in Gelb, Alan, Vijaya Ramachandran, and Alice Rossignol. 2014. “Should Countries Be More Like Shopping Malls? A Proposal for Service Guarantees in Africa.” CGD Policy Paper 047, September 17, 2014.

¹⁴ For India’s Aadhaar program see Gelb, Alan and Julia Clark. 2013. “Performance Lessons from India’s Universal Identification Program.” CGD Policy Paper Series, 20, Washington, DC: Center for Global Development. Such monitoring is now commonplace in service firms. United Parcel Service, for example, has made a massive investment in its performance tracking and monitoring systems to enable real-time feedback on distribution and deliveries and optimization of routes. See, for example <http://www.wired.com/2013/06/ups-astronomical-math/>



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