

**Domestic Finance Mobilization for  
Pro-Poor Infrastructure: An  
Exploration of Sub-Sovereign Finance  
Issues and Policy Guidance.**

**October 2004**

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### Foreword

Since the mid-80's governmental unit decentralization has become a well established trend worldwide. It entails the restructuring of intergovernmental relations and involves the reallocation of functions among several actors operating within the same country. While it may be true federalism it is an effective substitute. Many countries have pursued a distinctive path redefining the roles of the three levels of government and restructuring their administrative and fiscal relations. In this respect, Mexico, Brazil, Turkey, India, Indonesia and South Africa are interesting since their constitutions have granted, or are considering granting, a high degree of autonomy to provincial and local governments. China designed a unique path for the transition to a market economy where the sequence of reforms in the different sectors has been adapted to its own particular political situation and differs markedly from that followed in transitioning Eastern Europe and Russia. Central government continues to assume responsibility for the national welfare assistance and social safety nets. Local governments, NGOs and International Aid Organizations are the key actors in responding to the challenges of economic distress, social hardship small infrastructure projects (water, electrical, transport) and environmental degradation. Slums and squatter settlements are the physical manifestation of these challenges and reflect the added dimensions of social exclusion. Development banks, international and bilateral organizations, and Donor's have been the traditional source of funding for large infrastructure projects in developing countries and transitional economies directly or through financial intermediaries, particularly municipal finance institutions. These organizations continue to have a major influence on decentralization policies. As they included sustainable development, sound environmental management and more recently, poverty alleviation in their lending strategies, they have increasingly supported a range of institutional arrangements emphasizing partnerships among different levels of government and private sector participation. This has led to the development of more flexible lending instruments

adapted to the programs rather than projects. Perhaps a reason for the drop off in infrastructure financing as pointed out in: INTERNATIONAL FINANCING SOURCES IN SUPPORT OF "PRO-POOR/PRO GROWTH" INFRASTRUCTURE DEVELOPMENT (Chapter One) is the absence of comprehensive, integrated development plans for each country attempting to institute reforms.

In the discussion to follow recommendations are made relating to the furtherance of the decentralization process and a view to planning. A considered analysis of what works and why and what the current major issues are, is undertaken. A liberty has been taken through a designation that has been made for the intermediary representing interested institutions both international and internal/domestic. This amalgamated Interested Parties and Institutions intermediary is referred to as the Donor's.

## **I RECOMMENDATIONS**

1. **The Strategy.** Municipal, provincial and departmental authorities are becoming increasingly important and autonomous agents in providing the solutions for Infrastructure development. Nevertheless, the local services that make cities and the countryside good places to live and efficient places to work continue to be in poor condition. The Centralized Government models of the past seemingly found no value in 'Service to the People'. But technology may have changed that relationship, and when combined with tawdry results, the centralized bureaucracies have given way to the notion that all politics is local.

A considered response to the opportunities and problems of Sub-Sovereign development should be organized around four strategic emphases:

**(a) Defining the linkages between the public and the private sectors in supplying infrastructure services.**

Donor's should seek to include the role of private firms in the provision of public goods and services while strengthening the public sector's ability to incentivise, supervise and regulate these firms.

Developing the channels for citizens' participation will be of great importance to the strategy for improving public services.

**(b) Advocating market based financing for investment in feasible infrastructure.**

Donor's should seek to deploy a wide range of instruments to help link the escalating demand for infrastructure investment with the developing capital markets, both local and international. In conjunction with the public/private reforms these instruments will improve the quality and coverage of public services.

**(c) Advocate the development of asset ownership and registration.** Donors should help cities accommodate population growth more efficiently and fairly by working to remove pervasive distortions in land markets. In many instances land use regulations will need radical revision. In addition, Private ownership and registration of assets fixed and mobile will also assist in the creation of collateral and bankable credit.

(d) **Provide equitable access to local services.** Low income households have experienced disproportionate disadvantage when service coverage is incomplete or service quality is poor. Supporting the design and implementation of policies and instruments that promote equitable access to key services will be an integral part of DONOR projects. Well conceived subsidy programs will often be required.

2. **The Action Plan.** Donors should pursue this strategy, over the short and medium term, by means of the following principal actions:

- (a) Developing operations that tackle these issues in specific urban areas; presently Latin America, Sub Sahara Africa, and South Asia and appear to offer the most promising opportunities for 2005; a round of visits to the mayors of the capital cities of these countries to begin identifying a pipeline for these reforms.
- (b) Study means of linking Banking and Capital Market operations to state and municipal jurisdictions in Mexico, Brazil, India, South Africa, Turkey and Indonesia.
- (c) Develop a data bank of comparative empirical information.
- (d) Support Local governmental unit cooperation to exchange ideas and disseminate successes and techniques.
- (e) Training for Banking and Capital Market counterpart staff in innovative and cross disciplinary approaches to the problems of Sub Sovereign development.

3. **Institutional Mission.** The Donor's task force will be charged with helping develop a direct client relationship with Sub Sovereign authorities. In addition, the task force will help the counterparts achieve a consistent approach to the issues of Sub Sovereign development, through the programming of activities initiated by the country sub national units and the project activities initiated in the three 'Municipal' categories. Donorss will seek to identify mechanisms that, in the medium term, will allow Donors to go beyond individual projects and provide "wholesale" means of directly supporting, and financing, Sub Sovereign agencies. In short, an enabling intermediary for the Local Units and the international institutions charged with concern for this matter.

The following summarizes the problems and experiences in Sub Sovereign development that form the basis for the proposed strategy, and provides some additional detail on a prospective Donors plan of action.

## II SIGNIFICANT ISSUES

2.1 The departure point for the Donor's strategy is the recognition that many of the major challenges to improving welfare in emerging economies, now lie at the local level. With important reforms at the national level presumably currently underway, DONOR'S need to give greater emphasis to identifying arrangements that will help make municipality's better places for households to live and more efficient places for firms to work. Consequently, improving the quality of life for the urban population must be the immediate goal of all Donor's activities in this field. This section of the strategy paper

attempts to highlight some of the principal barriers to local development in emerging economies, and presents some promising policies for overcoming them.

#### ***A. Matching Responsibilities with Capabilities***

**2.2 Issue.** The guiding principle of successful Sub Sovereign development is arguable, to ensure that the devolution of executive responsibility is matched to the allocation of resources. Most legal reforms undertaken to promote municipal development in emerging economies have not been faithful to this principle. The mismatch often takes the form of vaguely delineated responsibilities for services, poorly considered and hastily designed fiscal policies and a lack of clarity in intergovernmental transfer systems. One empirical indicator of this mismatch is the low level of local expenditures. Developing Country municipalities, even the wealthiest, do not have more than about US\$75/capita/year to carry out the wide range of tasks and services for which they are responsible. Also, the actual process of decentralizing responsibilities may be as important as the design of the system itself. Implementation is not given appropriate attention. As a result, rules do not give sufficient account of the difference in capacity in different jurisdictions, nor to the importance of making sure that service levels do not actually deteriorate during the transition. Accountability and responsibility are presumptions of the desire for positive results. Local Units are far more likely to be held accountable for performance than a distant Central bureaucracy usually presumed to be corrupt or political to the disadvantage of the local citizenry.

**2.3 Policy recommendations.** What is needed, then, are:

- (i) better delineated mandates,
- (ii) better balances between fiscal rights and services obligations, and
- (iii) realistic plans for implementing reforms.

Because of their representative nature and their lobbying capacity, the national and regional municipal associations, may prove to be key stakeholders with whom DONOR'S should establish close working partnerships.

#### ***B. Governance and management***

**2.4 Issue.** There is little disagreement over the fact that the foremost obstacle to the establishment of efficient local governments in emerging economies lies in the limited human resources on which these incipient structures must rely. Local governments are only recently emerging as political forces after years of bureaucratic centralism. It is still difficult for local administrations to attract competent professionals due to low resource levels, narrow career structures and very limited personnel mobility between one jurisdiction and another.

Paradoxically, many national utilities and central governments are over staffed; draining resources that could be better used where, as the World Bank states, "the rubber meets the road". These strictly "managerial" issues are compounded by the uncertain links between local electorates and local governments. One key feature that is almost entirely lacking is objective, comparative information on municipal performance, which prevents "yardstick regulation" and strongly reduces political accountability. Without performance and accountability features the Private Sector will be without evaluation criteria and their

hesitant participations will reflect this factor. Results do matter. If results are without quantification or measurement then what is left to decide policy is politics.

**2.5 Policy recommendations.** (1) Reducing the number of personnel is no panacea and the analysis of staff needs must be done with honest prudence, but there is little doubt that, in many Sub Sovereign units and agencies, staff reductions are a key to increasing the resources available to begin a process of service improvement. To attract better qualified and more motivated professionals, as well as a method to control corruption, the average remuneration of personnel should approach equivalent private sector levels.

(2) At the same time, it is essential not to disperse the limited management capacity of Sub Sovereign unit administrations on non-critical tasks such as project execution or actual service provision, but to concentrate it on key issues such as financial management, regulation of urban growth, supervision of service provision, and the identification of local needs through increased community participation. Providing services should be left for contractors, who can be periodically evaluated and priced to market.

(3) It is therefore crucial to develop outsourcing and ensure that municipalities have greater access to the technical capacity of the private sector (both for-profit and not-for-profit). Outsourcing should not be limited to provision of basic services and infrastructure, but may also be successfully extended to support services such as information and fiscal management (e.g. tax collection, cadastre execution and maintenance).

(4) Donor commitment to and experience with measures to strengthen civic society can be brought to bear on local infrastructure issues. Public decision making in emerging economies can be opened up to a variety of participatory instruments. Social marketing can help governments explain complex issues and mobilize constituencies for reform.

(5) Finally, simple but comprehensive performance measurement systems must be developed to encourage better performance through increased accountability and cross-jurisdiction competition. This would also be an instrumental step toward the development of an efficient municipal credit-rating system.

### ***C. Service Provision***

**2.6 Issue.** Local public services (water, electric, transport), whether provided by local or national entities, deliver the same low level equilibrium characterized by low coverage rates. These same services stagnate when sources of capital investment are, as is usual, directed to older existing systems due to their accelerated deterioration. The result is a disconcerted and unreliable quality of service. The causes that lead to these symptoms are only too well known: operation and maintenance practices are archaic and cost-recovery mechanisms are ignored. The most disagreeable feature of this state of affairs is that it affects the poor particularly hard while often subsidizing access to services for higher income groups. This low-level equilibrium is rooted in three major factors:

(a) political interference, most notably in management, employment policy and tariff policy;

(b) lack of independent regulation and lack of competition, which suppresses the incentive to minimize costs and optimally allocate resources; and

(c) lack of users' involvement, which means that systems are usually designed with little knowledge of and no consideration for what end clients want -- and can afford.

**2.7 Policy recommendations.** The move towards decentralization will not solve the existing problems but may provide an opportunity to introduce three fundamental institutional changes.

(1) The first priority is to separate functions, most importantly service provision and regulation, and to define the role of each player very precisely. Is government in the regulation and supervision business, or in the water, electricity or transport business?

(2) The second step consists of insulating the service provider from political influence. The highest level of autonomy for the service provider should be systematically sought. This may be achieved by strengthening or converting to semi-autonomous status an existing entity, by creating a new semi-autonomous entity or by contracting a private entity to provide the services. Given the limited technical and institutional capacity of most developing countries municipalities, direct provision of services by municipalities should be completely discouraged. The introduction of market forces in services provision may be viewed as revolutionary, but actually is simple common sense.

(3) Once there is autonomy for the service provider, independent economic regulation is required to ensure that tariffs are commensurate with service levels and fair to both parties. Regulation should ideally be within a national framework to ensure consistency and that the necessary skills are used efficiently. In any event, the regulation should be aimed at local needs and resources.

(4) Finally, equity issues must be dealt with at policy level, i.e. by governments (whether municipal or central), not by service providers. As much as possible, transparent, targeted, meaning direct, subsidy plans should be developed. Although it is unlikely that there is a universal solution, a decent arrangement for most emerging economies could be to have:

(i) municipalities and local units, responsible for service;

(ii) private providers (or, in the absence of qualified private entities, a state or multi-municipal semi-autonomous agency) operating services under contract with municipalities; and

(iii) a central agency in charge of regulation and supervision

In smaller countries, it may well be appropriate to have a single economic regulator to cover all sectors. If there is no regulator at the central government level, then there is a choice between: (i) provisions for a regulator at local level; or (ii) regulation by contract.

#### ***D. The Structure of Sub Sovereign finances***

2.8 Sub Sovereign governments have three sources of revenues: they can mobilize resources within their own jurisdiction (local source revenues) they receive transfers from higher levels of government (transfers), and they can acquire debt. All three sources are in serious disarray.

## 1. Local Source Revenues

**2.9 Policy recommendations.** Service charges have the strongest potential for improving local-source revenues of local governments, even though they usually offer little appeal to local politicians. A policy of full cost recovery methodologies must be instituted -- while establishing transparent and direct subsidy schemes to take care of equity issues. Increased community participation in project design and tariff setting may ensure that project dimensioning and therefore tariffs are commensurate with user willingness-to-pay. Also, to specify the true cost of each activity and get the charges right, service-specific cost and revenue centers must be established. Local taxes often present less scope for improvement than currently believed, because central government has generally propounded a utility monopoly on efficient buoyant tax sources, leaving developing country Sub Sovereign government units with real estate taxes which are extremely expensive to administer (over 10% of revenues) or collect. Proposals to modernize cadastre, property valuation registers and the like can yield positive results but they should be very carefully evaluated since the more ambitious projects have a long record of generating negative return. Proposals should always be implemented from the billing/collection end first. More rational solutions may be attempted, for example allowing local governments to piggyback on national taxes. This would seem to make much more sense than striving to make every single local government unit an efficient tax administrator and collector.

## 2. Debt

**2.10 Issue.** Municipal debt in emerging economies has three main characteristics: (i) it is still very small, both in absolute terms and compared with the aggregate public sector debt (typically less than 5%, as opposed to up to 30% in more developed countries); (ii) it is concentrated in the largest municipalities; and (iii) it is funded almost entirely by publicly-owned development banks, most often with international aid funds.

This reflects the following basic issues:

- (i) there is a shortage of long-term emerging economy capital funding for local public services; see *INTERNATIONAL FINANCING SOURCES IN SUPPORT OF "PRO-POOR/PRO GROWTH" INFRASTRUCTURE DEVELOPMENT*
- (ii) there is limited amount of solvent demand for such funding on the part of municipalities; and
- (iii) the mechanisms used to channel existing funds introduce a series of biases and perverse incentives typical of any directed credit system, including the infamous moral hazard issue consisting of relieving local government borrowers from their debt obligations through central government bail-outs. Additionally, existing legal frameworks do not permit adequate collateralization of debt (very few municipalities can pledge their assets), do not ensure enforceability of contracts, and do not encourage information disclosure -- three basic elements unconditionally required to attract private investors.

**2.11 Policy recommendations.** Central government concerns regarding fiscal and monetary management will likely impose fairly tight financial constraints for the decades ahead. Within these constraints, Donor's should promote two steps.

(1) The legal framework that governs municipal lending should be amended to help 'incentivize' private lending to municipalities. This should include enhancing securitization mechanisms (e.g. allowing municipalities to pledge their revenues and assets), developing enforcement mechanisms (contract law, security law) and establishing rigorous policies regarding information disclosure, financial audit, publication and registration of all debt transactions. Transparency matters.

(2) Step two would be to develop a gradual sequence of expanding sources of funds with diversifying financing techniques. By comparison, the share of public resources that is controlled by local governments in emerging economies approximates 10 to 15%, while the same figure in more developed countries reaches 50 to 75%.

New instruments should be developed and pursued: the easiest deals may be financed through isolated project-finance type of arrangements (privatization, BOT); then, loans from commercial banks should be developed, which usually will better focus resources; finally, general obligation and special revenue bonds may be developed, perhaps beginning with similar terms to commercial paper, a prime capital market activity. Three specific services will be instrumental in helping develop emerging economies municipal credit market:

- (i) credit enhancement services;
- (ii) pooling mechanisms; and
- (iii) market-making intermediaries.

### **3. Inter-governmental transfers**

2.12 **Issue.** Inter-governmental transfer systems in emerging economies are without innovation in design as well as usually non-transparent. Normally these transfers are subject to political adjustment, corruption and under-supervised execution. These features make it virtually impossible for Sub Sovereign government units to meet their nominal responsibilities much less make honest, reliable, and implement able financial plans. Additionally, transfers do not provide any incentive for local revenue collection efforts and make little contribution to horizontal equity. Incentives matter.

2.13 **Policy recommendations.** Transfer systems must be aggressively redesigned to be made simple, transparent, automatic, counter-cyclical and equitable. This is not an easy challenge by emerging economy standards. Indeed a challenge not at all easy, but crucial. It is not clear if many countries will be receptive to reform these politically sensitive arrangements, but without serious reform, the scope for Sub Sovereign units progress will simply remain remedial and limited.

### **4. Expenditures**

2.14 **Policy recommendations.** Faced with a limited opportunity for increasing revenues, one cost-effective means of increasing discretionary expenditures for investment is to rationalize recurrent expenditures. This should be done by:

- (i) fighting corruption, notably through increased transparency (e.g. publishing financial statements and list of contract awards);
- (ii) divesting sources of outlays (e.g. instead of attempting to improve management of loss making municipal assets, proceed to market, sell, lease site or simply shut down); and
- (iii) establishing cost/revenue centers.

Also, mandatory allocations (e.g. no more than 60% of revenues or transfers can be spent on operating costs) have no intrinsic rationale. Although quite common, they should only be supported as last resort in some truly special local context. However, benchmarks of good practice and performance should be estimated in each country and used on regional basis to evaluate progress. Performance matters.

### ***E. Land Markets***

**2.15 Issue.** Land is truly the pariah of local development in emerging economies. In most countries, the vast majority of the population has no access to a formal or legal market in urban land: 60 to 80% of the process of urban expansion takes place informally, through illegal land occupation and unregulated subdivisions. For the municipal units, this imposes large additional costs during the attempted introduction of infrastructure. For households, the process involves great uncertainty with long periods of insecurity of tenure and inherently low levels of basic services. For all concerned, the current paradigm inhibits investment in housing, in infrastructure, and in public facilities.

There are three major causes behind this state of affairs:

- (i) the unreasonable regulatory standards that prevent land owners from providing low cost/low service plots affordable to low income households;
- (ii) oligopolistic land holding patterns reflected in widespread public holdings, the dominance by a very small number of private owners and the prevalence of peasant tenure; and
- (iii) the high development premium imposed by poorly managed utilities (particularly water and sewage), which forces the price of urbanized land above general utility.

**2.16 Policy recommendations.** Local government units would benefit from including land market reforms in any general modernization project. These will vary considerably according to local circumstances but in almost all cases, it will be important to deal simultaneously with the problems of improving the management of future growth, and with the problems of invaded land and irregular subdivisions that have been inherited from the past. In the end these measures are meant to ‘paperize’ assets which should result in more friendly investment environments.

Programs will generally include some of the following elements:

- (i) modernization of the land registry to provide fast, cheap access to records of title and liens, for both owners and third parties; providing ownership proof.
- (ii) regulatory reforms allowing low cost/low standard subdivisions;
- (iii) “final decision” legalization programs in existing irregular neighborhoods;
- (iv) a deliberate policy of fomenting competition in land supply through the planning of radial roads and potable water infrastructure. The political and financial fall out from the latter will be very difficult to manage without unusually open procedures for local participation and consultation.

Computerized records, simplified procedures, and subsidiary land registry offices in major municipal centers can often be turned into self-financing projects.

This measure, if it is not accompanied by regulatory reforms (ii), is doomed to be a failure. Investment matters.

### III. THE RESPONSE

3.1 In light of the fundamental issues which affect municipal unit development in emerging economies Donor's should develop their action steps along four principal conventions: redefining the interaction between private and public sectors, helping mobilize private capital for public investment, reform of land asset markets, and ensuring equitable access to basic services. This means that while any project will necessarily be closely tailored to the needs of the clients, Donor's will actively search out and emphasize the four areas where its contribution can be most productive. Framing these areas of strategic emphasis and outlining a plan of action to set Donor's response in motion follows.

#### A. Areas of Strategic Emphasis

1. Redefining the Boundaries: Innovating new linkages between public and private sector functions.

*(1) Develop instruments for private provision of public services: concession, lease, license, BOOT, and other.*

3.2 In the context of Sub Sovereign development, the term privatization, although widely used, is also widely misleading. It is evident that there is a large opportunity for increasing the role of private sector firms in resolving the problems presented above. DONOR'S will be able to play a crucial role in identifying the opportunities and supporting the process of change. The KfW Bank of Germany states the issue clearly in its Position paper dated January 2004 noted below.

“Since the beginning of the 1990s, the role of the state in the financing, construction and operation of infrastructure facilities has been increasingly called into question. The underlying rationale is that the state should concentrate on its core tasks. The state is expected to regulate the provision of power and telecommunication services but not to generate or produce them. Another related expectation is that public budgets should be relieved from the cost of expanding infrastructure and efficiency should be increased through the private operation of infrastructure facilities. In the last few years, the shares of public development assistance and private participation in the financing of investments projects have shifted markedly. Private investments are now six to eight times higher than public transfers. Today, in the economically advanced developing countries even infrastructure investments are often privately financed.

#### • Consequences for development cooperation

This paradigm shift also has an impact on German Financial Cooperation (FC). In some countries, FC has withdrawn from the financing of certain infrastructure projects for which commercial project financing is available now (e.g. telecommunications). Wherever possible and reasonable, priority is given to private sector involvement. Exclusively private models of infrastructure financing, however, are not realisable in all sectors and far from practicable in all countries. In poorer developing countries, a purely commercial financing of investments is hard to conceive. But even in those countries it is important to involve the private sector – for example in order to achieve more efficient cooperation or better customer service.

#### • Public-Private Partnership in the infrastructure sector – KfW's contribution

Private Public Partnership (PPP) in Financial Cooperation is possible in different forms and intensities. When deciding on these PPP projects' eligibility for promotion from a development-

policy perspective, the decisive factor is whether sufficient incentives for private enterprises are created in order to achieve a more efficient and sustainable supply of services. This is possible only when risks and prospects for returns are adequately considered in the design of the project and in the structure of the contract. So KfW sees its role in PPP projects not only in the financing of capital expenditure but primarily in supporting a sound reconciliation of interests between public and private protagonists. In addition FC also contributes to dismantling structures that hamper development (such as low collection efficiency in billing to customers, tariffs that fail to cover costs) in investment projects with public executing agencies or, particularly in the preparation of new projects, through sector dialogue. This improves the conditions for the private sector to get involved.

• **From sector reforms to Public-Private Partnerships in FC**

Public sector reforms often lead to private-sector solutions. Utilities hitherto supervised by ministries are incorporated as enterprises and prepared for profitable operation (commercialisation). At the same time some activities are often also outsourced to private enterprises. For example, in Uganda the maintenance of all locomotives of the Ugandan national railways was transferred to a private joint venture in which the German locomotive manufacturer participates. In most cases, however, the role of the private partner goes further. Under a *management* or *leasing* agreement it assumes responsibility for the *operation* of the *entire enterprise* for an agreed period of time. Remuneration depends on performance-related success indicators such as the reduction of water losses in the operation of a water supply company. Under leasing agreements the private partner also assumes not only the responsibility for operation but also the *entire commercial risk* of the enterprise against payment of a lease. While the private operator finances maintenance work under management and leasing agreements the public authority is still responsible for the necessary capital expenditure, for instance in grid expansion. This authority, in turn, can be supported under FC. So for instance, under the programme "Rural Electrification South Africa", which is being financed by FC funds, the public executing agency is being supported in its selection of a private operator. In a more advanced form of public-private partnership the private enterprise can also *acquire shares in the equity* of the formerly purely state-owned enterprise or *take long-term concession rights*. If it does it must necessarily participate in the financing of capital expenditure as well. For the remaining portion of the investment to be financed from budget funds, FC funds can again be made available. This has enabled a German enterprise to take a concession for the operation of an urban water supply system in Albania despite widespread poverty. Not only the operation but a considerable portion of the capital expenditure is being privately financed. On the basis of its many years of cooperation with many countries KfW can offer many different ways of preparing PPP solutions by financing studies and accompanying them through the financing of capital expenditure. In this its main concern is that PPP solutions benefit poor groups of the population in particular.

• **Promoting the private sector - not a new subject for FC**

KfW has traditionally promoted the private sector under FC, for instance by making credit lines available to refinance financial institutions in developing countries, particularly for lending to small and medium-size enterprises. Among other purposes, these credit instruments are designed to help create income and employment, to improve the environment or to promote the informal sector."

*(2) Identify outsourcing of internal support services.*

3.3 Infrastructure projects will also identify outsourcing opportunities of internal support services (cadastre execution and maintenance, tax collection, billing and bill collection, land registration, outcome measurement, others) and will help develop local government's capacity to manage this new environment.

On May 20, 2002, East Timor emerged as an independent nation, with Australia playing a key role in East Timor's transition to independence. The Australia - East Timor Capacity Building Facility (AETCBF) is an Australian development cooperation project designed to help the Government of East Timor and East Timorese small businesses and non-government organizations develop the skills needed to provide services to the people of East Timor. The Facility supports capacity development in public administration and service delivery in the areas of health, rural development, water and sanitation, governance and education. The Facility will develop policy, regulatory and administrative frameworks and systems that will contribute to long term economic growth in East Timor. The project is based on a strong partnership approach and provides short and long term technical advisers, training programs, and policy research and development that will build the skills base of East Timorese government employees at both the central and district levels. Activities include training and language support, finance advice, environmental testing and assistance for tax officers and budget preparation, support for small and medium industries, civilian law enforcement advice, human resource planning and the development of a local government database. The project is managed by Australian company Illawarra Technology Corporation (ITC) on behalf of the Australian Government.

*(3) Strengthen local government regulatory capacity.*

3.4 Equally important for this approach to work is a change in the focus and an increase in the effectiveness and capacity of the public sector (not necessarily its size). Managing bids for concessions, monitoring compliance with performance contracts, supervising outsourced functions, enforcing strong regulatory functions, are different from, and more demanding than, the traditional tasks undertaken in local governments and public utilities. If these are not attended to, the process of reform will bring few of the expected benefits. Donor experience with the historically more mature public sectors will therefore play a central part in project designs.

The Japan International Cooperation Agency sponsored the **Project on Strengthening Sulawesi Rural Community Development to Support Poverty Alleviation Programs**, in Indonesia. The Project-type was Technical Cooperation (March 1997 - February 2002) Indonesia is made up of a number of islands, each having its own social, cultural, and economic conditions. Despite this fact, the Indonesian political system tends to concentrate power in the central government, and consequently policies and strategies devised by the central government are enacted through regional agencies in a uniform manner. This has resulted in the specific characteristics of the regions being ignored, and the fact that the needs of local residents are not reflected in government policy. This project was implemented in the developing region of Southern Sulawesi. Its

objectives include the fostering of local residents' capabilities in identifying issues and needs in the region, establishment of an administrative structure that makes the implementation of development projects satisfying these issues and needs possible, and provision of training for Rural Community Development Office personnel.

## 2. Private capital for Public Infrastructure: from administered supply to market discipline

3.5 Donor's can play a key role in the task of channeling resources from the capital markets to Sub Sovereign unit agencies. Increasing municipal investment is an important target in itself; equally important, it is a powerful inducement to undertake necessary but politically sensitive policy decisions. These decisions, regarding incentive structures, ownership arrangements, service charges and the like will certainly make local governments, utility companies and private providers of public services attractive and accountable to investors. They will also break the log jam that has held back the improvement of local services over the past three decades.

### *(4) Cut off public development banks from non-market sources of finance*

The IFC has made a tangible effort in this regard. It is proposed that IFC structure a US\$200 million transaction for Akbank in Turkey, comprised of a US\$100 million bond backed by credit enhancement granted by IFC for up to US\$20 million, in addition to a syndicated term loan package, composed of a ten-year A Loan of up to US\$20 million and a seven-year B Loan of up to US\$80 million. JP Morgan, as the placing agent, intends to place the majority of Akbank's bond and the B Loan with both US and non-US institutional investors. Akbank would use the proceeds of the financing to provide term finance to the Bank's corporate clients and small- and medium-size enterprises (SMEs), and develop new retail products such as housing and consumer finance. The IFC loan would extend the maturity of Akbank's funding base, enabling the Bank to provide term finance to private-sector enterprises in Turkey, and would support Akbank's strategy to increase lending to financially sound SMEs. Lending to SMEs currently comprises 40% of Akbank's total loan portfolio. The project would be the first instance of Akbank tapping the institutional investor market for a dual structured and non-structured finance transaction and would, therefore, introduce the Bank to a new class of international investors. Moreover, exposure to the international capital markets and IFC's involvement would enhance Akbank's standing by introducing the Bank's credit, on its own merit, to investors.

### *(5) Develop alternative financing instruments*

The World Bank offers an array of instruments including loans and grants to finance poverty-reduction and economic development efforts around the world. The Bank has many types of financing instruments. See: [worldbank.org/websites/external/projects](http://worldbank.org/websites/external/projects)

### *(6) Leverage Donors general resources (Combined Financial Statements) with private financing.*

The World Bank Group has two basic types of lending instruments: investment loans and development policy loans. Investment loans have a long-term focus (5 to 10 years), and finance goods, works, and services in support of economic and social development projects in a broad range of sectors. Development Policy loans have a short-term focus (1 to 3 years), and provide quick-disbursing external financing to support policy and institutional reforms

3.6 The first area that requires attention concerns the sources of emerging economies financing. Public sector investment banks have been the traditional vehicle for channeling resources to the cities; in most host economies, these have not proven to be effective at pursuing financial or welfare goals. Investigating alternative arrangements is therefore very important. Given the range of utilities, jurisdictions and investor needs, it is clear that no single instrument will be adequate. A range of financial options must be available and Donor's strategy will be to support an environment in which lending by commercial banks, equity investments, and bond issues in emerging economies all play a role. Both strategic investors bringing technical and managerial expertise as well as portfolio investors should be able to participate.

3.7 In some countries, special purpose financial vehicles with private participation may be able to play a role. Ideally, private participation would involve some financial stake. Donor's presence may encourage emerging economies or international banks to take part by providing protection against some political risks. While the private financial sector remains relatively weak and thin these arrangements may provide a bridge or path out of the public sector enclaves that have been the traditional responses.

3.8 Donor's has a number of different sources/modes of facilitating lending to promote private financing of development in emerging economies: (i) direct lending (or guaranteeing) by Donor's to a private party in emerging economies of privatization; (ii) structuring mixed market/concessionary financing deals; and (iii) specific revenue bond issues, for which Donor's could help structure the deal, place part of the issue or provide a take out guarantee. As an example, the World Bank used MIGA for the residents of Rocinha, one of Latin America's largest and oldest slums. The residents of Rocinha struggle to find work and have access to basic social services. Their struggle is exacerbated by the threat of fire, electrocution and power outages. These additional risks stem from the often desperate steps residents take to bring electricity to their meager homes, which are often connected illegally and with extreme risk to the power network. Part of the solution is to find ways to deal with infrastructural inadequacies, to provide essential services at a low cost, and to educate residents about proper power usage, in Rocinha and in other slums in Rio de Janeiro. Such an effort is being undertaken by Light Serviços de Electricidade SA, Rio's main power provider, as part of an ongoing program to upgrade the city's electricity transmission and distribution systems. This initiative is made possible by a \$200 million loan, a portion which is insured against noncommercial risks by a guarantee from the World Bank's Multilateral Investment Guarantee Agency (MIGA).

*(7) Make sub-national governments attractive to private lenders through financial restructuring as well as with legal and regulatory reforms.*

3.9 The next area that requires attention is the creditworthiness of the would-be borrowers. Programs will need to take an active role in demonstrating how a thorough going financial workplan can enhance the standing of emerging economies borrowers. Such a workplan could include the traditional “strengthening” activities of increasing own income sources and reducing current expenditures. Restructuring debt on more favorable terms may also be required in some emerging economies. Perhaps the largest unexplored source of improving the financial capacity of borrowers is related to service concessions. Setting up some kind of concession arrangement so that a private firm is responsible for some service, has a double effect. The private agency can itself assume some investment responsibilities; this takes the “public” investment off the municipality’s books. At the same time, the municipality’s borrowing capacity is released for use on projects that do not lend themselves to privatization. As described above, emerging economies legal and regulatory regimes need to be reformed in most countries to create an environment in which private investors face lower risks, better information, and more reliable procedures for dispute resolution.

This is the path of perfection. In practice two less elevated recommendations will probably be more applicable: a) Move towards market rates for emerging economies borrowing; b) Ensure that any concessionary funding is “paid for” by significant measurable reforms, some of which are accomplished as pre-conditions for borrowing. These recommendations are clearly pragmatic and therefore perhaps, too utopian. But the risk of perpetuating the existing public enclaves is very much higher.

The USAID’s Development Credit Authority recently provided a Bond Guarantee (\$6.4 Million) to **Tamil Nadu W.S.P.F.** to support the establishment of a fund for municipal infrastructure projects, a pooled financing mechanism to provide a cost-effective way for villages, towns and cities in the Indian state of Tamil Nadu to implement much-needed water and sanitation projects. The facility promoted under the Indo-USAID FIRE project, municipal bonds have been enthusiastically received by numerous municipal authorities in India. This bond guarantee supports the establishment of the “Water and Sanitation Pooled Fund” (WSPF), which will on-lend \$6.4 million to multiple municipal water and sanitation projects. The funds raised by the bond issuance are disbursed as sub-loans to the participating municipalities for these projects. One example is the township of Valasaravakkam, with a population of 26,260, which has no adequate water supply system, relying on open and bore wells and three above-ground tanks, connected to 11 miles of piping. This system provides an estimated 2 liters of water per person per day. This is one of a number of innovative DCA projects in India that have given access to financing for water and sanitation projects to benefit the urban and rural poor. It is the first to incorporate many of the aspects of the CWSRF program.

*(8) Develop methodologies and services for credit enhancement*

*(9) Promote use of credit ratings*

3.10 This leads to the third area of attention: developing the key support services that facilitate direct private lending to local jurisdictions. DONOR'S can help introduce various forms of credit enhancement, debt pooling, and market making, using some of the instruments listed above. In addition, credit rating agencies from the USA and Europe are already beginning to be active in Latin America and South Asia. Exposure to the culture of financial disclosure will be as important as the more technical aspects of the financial evaluation involved in getting a rating.

### 3. Land market reform and the management of urban growth

*(10) Ensure land market reforms are systematically addressed.*

3.11 Donor's role here should, in the first instance, be to ensure that this aspect of local development is no longer neglected. The kind of measures to promote efficient land markets, described in paragraph 2.15 above, are not particularly demanding to implement from a technical perspective. Donor's however can play a critical role in demonstrating the perverse effects of setting high regulatory standards or of importing planning techniques from industrialized countries. Transitioning from informal to formal markets is no longer a theory, but a clear reality.

*(11) Foster innovative land registration projects.*

3.12 Traditionally, consulting firms in this field have emphasized diagnostic services and the supply of technical (hardware and software) equipment. Donor's may be in a position to encourage such firms to undertake more comprehensive assignments, BOOTs for property cadastre, for example.

*(12) Facilitate information collection and dissemination.*

3.13 As part of this focus, Donor's will need to collect comparative data such as models for reform and examples of how not to arrange matters, development standards, development costs under different regulatory regimes, and indicators to help localities carry out self diagnoses and conditionality. Selective use of the housing and urban indicators developed by the WB, IFC and UNDP will be an effective starting point for this task.

The Department For International Development is currently conducting an important review on conditionality strategy entitled:

*'Partnerships for poverty reduction: changing aid conditionality'*

This paper has been jointly produced by DFID, the UK Treasury, and the FCO, and is the UK Government's first comprehensive policy statement on conditionality - the conditions which donor countries apply to their aid. The paper emphasizes the need for developing countries to be in the driving seat of their own policies on poverty reduction, and reflects

an important shift away from traditional approaches to conditionality. The consultation process on the UK paper will continue until **November 30th**. Comments are invited and should be sent to [conditionality@dfid.gov.uk](mailto:conditionality@dfid.gov.uk)

#### 4. Providing equitable access to local services

*(13) Helping the public sector articulate equity issues into reform dialogue.*

3.14 The low coverage and poor quality of basic urban services (water, sanitation, garbage collection, and security) affect the low income population quite disproportionately. At the same time, the existing arrangements, however sub optimal in practice, have been defended with arguments based on concern for the welfare of low income households. Resistance to reforms in areas such as water tariffs, transport fares, tax policies and public land banks are examples of this concern. Here, Donor's ability to help articulate an "equity" policy will play an important role in making reforms politically acceptable. DONOR resources can also help reduce the political costs of the transition period. The DFID has weighed in on this issue in Uganda. The Uganda government has a strong decentralization program. However, collaborative research led by the University of East Anglia showed that decentralization of taxation and privatization of revenue could impose punitive burdens on economic activity and rural livelihoods – the opposite of what was intended. This has led to changes in the implementation of the government's Poverty Eradication Action Plan (PEAP).

*(14) Support arrangements that increase access of poor to services*

The State and Local Government Program (SLGP) is a DFID funded initiative supporting effective pro-poor state and local government administration in four key Nigerian states: Jigawa, Benue, Ekiti and Enugu. SLGP aims to enhance the capacity and competence of state and local governments to formulate policies, manage resources and support service delivery in the interest of poor people.

In January 2002, the program team based in Enugu State embarked on a demonstration project on Solid Waste Management to show government and other stake-holders that improvements in service delivery are possible, and in so doing yield more immediate and tangible poverty reduction outcomes. The Project was designed to improve service delivery by providing a cleaner and healthier environment. Various institutional reform gains have been made during the pilot, although there are some difficulties in improving the actual services delivered to residents. Over time, several issues will need to be tackled, according to DFID, if this project is to be successful.

Two key issues:

-the tendering and procurement processes used and the effect on the state government's procurement practices

-the involvement of civil society in the delivery of this initiative program and the roles of residents and end beneficiaries in the design, delivery and future monitoring of the program.

The outcome will enable the project team to draw links between environmental management and public health.

3.15 A wide variety of instruments are available for ensuring that financially sound reforms for the provision of local services polices emerging can be combined with actual improvements in the access of low income households to services. Performance contracts can include service extension in low income neighborhoods, while explicit subsidies can be used to provide effective incentives for compliance. Taxation and tariff arrangements should always be carefully analyzed to ensure that low income households do have access to basic municipal services of the appropriate quality. The USAID developed an innovative facility in the form of the Municipal Infrastructure Investment Unit (MIIU). This USAID portable credit guarantee (\$35 million) will cover up to 50% of the risk exposure held by a set of lenders on the principal (and interest) of loans extended to qualifying non-sovereign borrowers defined as municipalities endeavoring to improve the quality and sustainability of essential municipal services, particularly water supply. The loans extended under the guarantee will enable municipalities to invest in infrastructure projects and purchase equipment necessary to improve levels of service and enhance the generation and collection of related revenues. In this way, municipal service provision can develop in a sustainable manner.

## **B. Proposed plan of Actions**

**Action 1.** Develop specific operations.

3.16 Assist specific municipalities in acquiring access to capital financing and/or improve their management through technical assistance. This is likely to be instrumental in implementing the Donor's proposed strategy in creating a solid basis for municipal development in developing countries. Priority should be given to municipalities which have proven their commitment to structural reforms consistent with the principles outlined in section A above and to operations which would have a demonstrative impact not only toward other municipalities in the host country but also towards the local and international capital markets.

3.17 Operations with specific municipalities could be structured in two components: (1) an institutional reform component with emphasis on financial (fiscal and budgetary) management, service provision, human resources and performance measurement, and (2) an investment component to finance the improvement/expansion of a given service/infrastructure. There would be a clear link between the progress of reform and the disbursement of investment funding.

3.18 Presently Mexico, Brazil, Turkey, India, Indonesia, South Africa appear to be the most promising economies for DONOR action.

3.19 Although the actual structure of investment financing will vary from deal to deal, two guiding rules should apply systematically: (a) infrastructure financing should be provided at market conditions only; (b) project incomes should be the foremost source of repayment. This will automatically favor stronger over weaker municipalities and the

notion of self-financing versus social projects. The proposed strategy is precisely to work with stronger municipalities first and do whatever is necessary to get them out of concessionary financing --which, in turn, will free resources for weaker municipalities and/or more social projects.

**Action 2.** Develop comparative empirical information.

**3.20 Quantitative Indicators.** Donors should help compose a simple database to compare the performance and basic needs of municipalities. With this database Donor's would identify a key set of indicators and collect data from a sample of selected cities, tentatively of the selected six countries major metropolitan areas and some secondary cities in each of the six selected developing countries.

**3.21 Case studies of successful outcomes.** Donors would then help establish a data bank of concisely presented successful cases for specific themes. The take over of potable water services by the municipalities in Mexico and Brazil are good starting examples. Indicators would be clustered into four broad categories: (1) local economy and demography; (2) municipal finance; (3) service coverage and performance for potable water and sanitation, urban transport, solid wastes, electricity and telephone; (4) housing and land market..

**Action 3** Develop committee's for regional dialogue.

**3.22 Regional Dialogue.** This set of activities would enable Donors to initiate a dialogue with the major actors in the field, in order to refine the proposed strategy and establish the legal basis that it requires. This would include the activities outlined below.

(a) A first study would aim at carrying out a comparative analysis of existing municipal legal frameworks in developing countries and checking legal provisions against what is really occurring in the field. This could provide the basis for a municipal legal agenda as a model.

(b) A second study would investigate the existing obstacles to the development of a regional municipal credit market. It would consist of an analysis of the solvent demand for long-term financing by subject municipalities, and would be followed by an analysis of the supply of long-term credit looking at features such as existing legal and regulatory obstacles, present forms of savings, potential investors, and the need for credit enhancement mechanisms.

(c) A more generic study could review successful municipal credit markets around the world and draw lessons applicable to international best practices.

(d) Specific country studies could be carried out in the countries where Donor's currently operate. These studies would look into the institutional capacity of municipalities and into their basic needs.

(e) Last but not least, Donor's could finance annual meetings with a selection of sub sovereign issuer's and municipalities replete with training seminars, centered on municipal finance.

**Action 4.** The 'wholesaling' issue.

**3.23 Wholesale Vendor.** Donors should be able to review the appropriateness of establishing a regional investment mechanism to channel funds from the financial markets to emerging economies municipalities. Clearly, a gradual approach will be needed. Based on the results of the first set of studies, the following options should be looked into.

(a) Donor's would provide financing to a regional second-tier bank. This second-tier bank would on-lend donor resources to qualified commercial banks, which would in turn grant loans to municipalities.

Such loans would be at market rates and commercial banks would take all credit risks. The differential between Donors conditions and the market conditions would be "recycled" to finance technical assistance.

(b) Another option would be the establishment of a regional mechanism by which municipal debt could be bundled, enhanced and marketed on the regional or international financial markets. Such a mechanism could take the form of a regional municipal bond bank, in which case determining the right ownership structure would be critical to reduce moral hazards. This mechanism would only take care of on-lending resources made available by Donors. An important sustainability issue would remain. By contrast, this mechanism would also raise funds.

(c) Whatever investment instrument is selected, a few critical support services will be needed to help the development of a regional municipal credit market. Donors should help establish such services as credit rating, financial and legal services (structuring of municipal financing deals), credit enhancement and insurance mechanisms, liquidity facilities (development of secondary markets)

**Action 5.** Personnel training.

**3.24** This proposed strategy and, more generally, the field of municipal development would be relatively new to Donor's staff and national counterparts alike. Since this field is emerging from the integration of several formerly isolated disciplines, cross-training and exchange of experience should be an important part of staff development.

**3.25** International training providers should develop on-the-job, project and issue-specific training and should be called upon to sponsor workshops and more formal training.

**3.26** As much as possible, training targeted to all staff should also include national counterparts (from both the central and local governments) as well as regional municipal associations.

## **CONCLUSION**

In constructing a ship, a methodology or a philosophy, one must go all the way. Any effort that is in principle incomplete will be more a burden than assistance. The aim of this effort is to serve as a lens for presenting different views of the cathedral of sub-sovereign infrastructure finance and a foundation for completing projects, both the project of creating a public credit market in emerging economies and that of creating actual projects. The expanding scope for the Donor's has not diminished the public role. At higher levels of government this role has shifted from provider to enabler by: providing incentives; streamlining procedures and adapting regulations; and contributing to project financing. At the local level the shift has been towards partnerships between local governments, the private sector and NGOs. This situation is leading to an increasing emphasis on participatory processes, transparency, accountability and empowerment. In some cases creative partnership initiatives have been institutionalized within the structure of local governance. It is a positive trend.

**DRAFT**

