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Overview and Outline

This book is based on a study commissioned by the Commonwealth Secretariat on municipal infrastructure financing in selected Commonwealth countries. The study was undertaken by the Cambridge Economic Policy Associates (CEPA). It was intended to inform the policy community on the key constraints in financing municipal infrastructure and services in Commonwealth developing countries, and present some alternative infrastructure funding options based on illustrative success stories globally.

Decentralisation is taking place in most countries of the world, including the Commonwealth, albeit at a varying pace. According to an estimate, about 80 per cent of the developing countries have introduced some form of decentralisation over past decades.¹ Consequently, local governments now have greater responsibility for service delivery and also for achievement of the Millennium Development Goals. One of the crucial issues for local governments is the availability of adequate finance to provide quality services to their constituents. This not only involves the ability to mobilise financial resources, but also to use those resources effectively and efficiently. It is a known fact that there is a chronic shortage of money in local governments. Sometimes the situation worsens to acute when local governments are assigned the delivery of devolved services, without being given adequate matching resources by central government.

Another related issue is rapid urbanisation, which puts the service provision capabilities of local governments – who are already finding it difficult to keep pace with the rising demand – under even greater pressure. The mounting fiscal constraints and infrastructure-financing gap in most countries have together resulted in governments seeking to mobilise alternative financing for infrastructure from the private sector. Consequently, governments are facing new challenges in terms of attracting private sector financing and participation. These challenges include issues such as developing appropriate legal and regulatory frameworks, preparing ‘bankable’ infrastructure projects, and developing capital and credit markets to access long-term infrastructure finance.

As stated above, faced with ongoing urbanisation and the mounting gap in financing municipal infrastructure, the typical options for local governments are borrowing from financial institutions and development banks, accessing capital markets or soliciting private sector participation through contracts, leases and

concessions. According to World Bank estimates, between 1990 and 2006, privatisation attracted more than one trillion dollars worth of investment in infrastructure in developing countries.² However, basic urban services such as water supply and sanitation, sewerage and solid waste management are unattractive to the private sector for a number of reasons, including limited cost recovery, high risk and long gestation investments. At the same time, in the context of developing countries, liquidity and financial products are typically limited in availability, while loans from banks and financial institutions are often of short tenure (up to 5 to 7 years), and may require sovereign guarantees. Hence, many developing countries are trying to develop domestic and international capital markets to mobilise private savings for urban infrastructure involving lengthier payback periods.³ Access to capital markets by sub-national governments is important for another reason. Infrastructure investments benefit future generations, so equity requires that future generations should also bear the cost of financing.⁴

The situation of (municipal) infrastructure financing in developed countries, including Commonwealth countries, is quite different. In Anglo-Saxon countries, there is a significant history of drawing on the private and voluntary sectors to deliver public services. Countries such as the UK, New Zealand, Canada and Australia have led the way in the development of public-private partnerships (PPPs) over recent decades. Today, PPPs play an important part in expanding public infrastructure throughout the European Union. This book provides a succinct review of international practices, including developed countries of the world.

An overview of municipal infrastructure financing in Commonwealth developing countries

Against this backdrop, the book seeks to provide an overview of municipal finances and the extent of private sector involvement in the delivery of municipal services in selected Commonwealth developing countries. This includes a review of the current market for infrastructure financing at the sub-national level, across the Commonwealth developing countries. It also looks at the specific patterns and gaps in municipal infrastructure financing, based on the demand for infrastructure projects and the available sources of financing. The analysis of the current financing sources covers public, private and donor funding of infrastructure projects. As part of this review, an assessment of the extent to which the capital and credit markets in these countries are developed to provide financing for infrastructure projects, has also been attempted.

Given the varying degrees of fiscal decentralisation, capital markets development and the economic base of municipalities across countries, as well as the diverse infrastructure financing approaches, it was decided to adopt a case study approach to this overview. In order to provide a representative sample, two Asian Commonwealth developing countries and two African Commonwealth developing

countries were selected for the study – these are Bangladesh, Pakistan, Tanzania and Uganda.

An understanding of alternative options for innovative municipal infrastructure financing

Given the rapid urbanisation of cities and the constraints in public financing of their growing infrastructure needs, several countries are exploring alternative means to mobilise additional municipal financing, particularly by attracting private sector participation in infrastructure services. In this book, an attempt has been made to present various innovative municipal infrastructure financing initiatives that have worked across other developing and developed countries. Examples of such options include the issue of municipal bonds, pooled financing initiatives across municipalities, and the establishment of municipal funds or different forms of public-private partnerships, with the objective of attracting private sector financing or donor support for infrastructure projects.

Challenges

The book also aims to identify the key challenges and constraints in municipal infrastructure financing, including any broad institutional and financial strengthening measures that are required to tap alternate sources of financing for infrastructure investments. While the report of the study focuses on drawing lessons relevant for the case study cities/countries, some of these suggestions will apply across developing countries that face similar challenges with regard to infrastructure development.

In terms of methodology, the study commenced with desk-based secondary research of relevant literature and municipal data. However, given that the area of local government finances in developing countries has not been extensively researched, the desk study was supplemented with primary research involving semi-structured interviews with key stakeholders in the municipalities and relevant private infrastructure investors in the selected case study countries. The statistics stated in this book are based on the ‘best available’ estimates provided by the respective government agencies. Where there are gaps or inconsistencies in the data or reporting formats thereof, the researchers have tried to reconcile the figures and present them as coherently as possible.

Structure of the book

Following this overview, chapter 2 sets out the broad context and background of the study. It has been argued that although ‘finance follows function’ is a cardinal principle of decentralisation, in practice fiscal decentralisation has not taken place along with administrative and functional decentralisation in most developing

countries. As a result of the varied pace of fiscal decentralisation, and the differences in size and economic prospects, there is a significant difference in sub-national fiscal structures across developing and emerging market countries. This chapter touches upon various sources of municipal finance across emerging market and Organisation for Economic Co-operation and Development (OECD) countries. It also sets out the international experience in accessing alternate sources of financing, such as through issuing municipal bonds.

Chapters 3 to 6 present the detailed case studies on Dar es Salaam, Kampala, Karachi and Dhaka respectively. Briefly, in Dar es Salaam (Tanzania), private sector participation (PSP) is fairly nascent, both at the national and municipal levels, and is limited to the contracting out of specific municipal services such as solid waste collection, bus terminals and parking services. Municipal borrowing for infrastructure investments has not taken hold, and local governments need central government permission to borrow. Although the Local Government Loans Board acts as a specialised public municipal lender, borrowing is negligible.

Similarly, in Kampala (Uganda), the city council has been contracting out services like solid waste management; however, a regulatory framework to strengthen PSP at the national and sub-national levels is yet to be established. Private sector capacity to provide and finance infrastructure services has been harnessed to a limited degree in the city. Borrowing is allowed by law, but confined to a maximum of 25 per cent of own-source revenues. Kampala has yet to access market finance. The financial sector is evolving and long-term government bonds have been taken up comfortably. However, market financing has not been pursued at the municipal level.

This study shows the situation in the (selected) Asian cities to be similar. In the case of Karachi (Pakistan), the level of PSP is limited to the private contracting out of services such as solid waste and markets. Through a donor- (the Asian Development Bank) funded infrastructure development project, the Karachi Megacity Development Project, it is expected that the institutional environment for private sector participation will improve, as the project is also poised to set up a special finance vehicle to harness private sector finance. In parallel, although the banking sector has experienced growth, there is a liquidity gap for infrastructure finance.

In Bangladesh, private sector capacity and willingness to engage in infrastructure projects, particularly at the local government level, remains weak. In Dhaka, PSP activities are limited to the contracting out of services such as solid waste management. Dhaka City Corporation is legally entitled to borrow for its capital investments, but it has only done so largely for working capital purposes. In this context, the government-owned Bangladesh Municipal Development Fund (BMDF) was set up under a World Bank credit to provide financial support for municipal infrastructure projects. Local financial markets are nascent, which constrains access to market finance for infrastructure projects. Moreover, municipal borrowing entities

are not considered creditworthy enough to tap private debt and ensure its timely servicing.

Chapter 7 sets out some innovative municipal financing approaches that have been successful across developing countries. These include examples of mobilising financing from the capital markets and attracting private sector participation in the provision and financing of municipal infrastructure.

Chapter 8 concludes by summarising the challenges of municipal infrastructure financing, and discusses some of the key financial and institutional strengthening measures required to mobilise alternate sources of financing.

Finally, chapter 9 provides references, both primary and secondary sources.

Conclusion

Infrastructure constraints are a major obstacle to human and economic development. The governments of the developing Commonwealth countries lack financial resources to meet current and future infrastructure needs. It is within this broad context that this book has been written. It is sincerely hoped that these four case studies and review of the literature will provide the ‘pros’ and ‘cons’ of borrowing by local governments to public sector policy-makers. I hope that readers will appreciate that borrowing by sub-national entities is not that simple, that it is a complex issue which can sometimes have a serious impact on macro-economic management. For example, in Argentina, public banks provided loans to finance the deficits of sub-national governments, contributing to macro-economic imbalances, as well as stifling incentives to change inefficient service delivery mechanisms.⁵ This book therefore argues for more stringent technical and financial scrutiny on projects that are to be financed from loans, as compared to projects financed out of the recurrent budget. Decentralisation and attempts to finance municipal infrastructure through non-conventional means should be accompanied by stronger project preparation and development capabilities of local governments.

It is increasingly argued that when developing countries want to try non-conventional modes of financing service delivery, or where more responsibility is devolved to local bodies, then care must be taken to ensure that appropriate arrangements exist, or are created where they do not exist, in order to ensure the stewardship of public money. It must be remembered that such ‘innovations’ cost, in terms of both money and time, and carry their own overheads.⁶

Notes

1. Commonwealth Secretariat (2009).
2. Gomez-Ibanez (2008).
3. Venkatachalam (2007).
4. Ahmad et al. (2005).
5. Ahmad (1996).
6. Chartered Institute of Public Finance and Accountancy (CIPFA) (2005).