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Conclusion

As mentioned in the introductory chapter, this book seeks to identify some of the key challenges in municipal infrastructure financing and to provide broad suggestions for financial and institutional strengthening of sub-national governments so that they can mobilise alternate, including private, sources of financing for infrastructure investments. The sections to this chapter describe some of the key challenges of and the suggested financial strengthening measures to mobilise private sector financing for sub-national infrastructure projects.

Challenges of municipal infrastructure financing

The detailed case studies presented on four Commonwealth developing countries – Uganda, Tanzania, Bangladesh and Pakistan – underscore the gaps in fiscal decentralisation and the constraints faced by municipalities in promoting new growth-oriented infrastructure and public services. Given the rapid urbanisation across major cities and the growing demands for infrastructure investments, several local governments such as the Kampala City Council are undertaking initiatives to strengthen their traditional sources of tax revenues and user charges. However, there still exists a significant infrastructure financing gap at the sub-national level.

Based on the lessons derived from the four case analyses, the following are some of the key demand- and supply-side challenges faced by municipal authorities in the provision of local infrastructure and services:

- *Limited fiscal devolution of powers:* Whilst in theory, ‘finance follows function’, the reality in most developing countries is that local governments are not equipped with adequate revenue generating powers commensurate with the demands of local development. The financial decentralisation in Pakistan to provincial and local governments is a case in point. Federal receipts comprise nearly 80 per cent of provincial revenues, and further transfers and devolution account for a majority of local revenues. The ownership and levy of property tax, one of the major sources of local revenues, is still a disputed matter between the different levels of sub-national government. In the absence of sustainable sources of local revenues, local governments have limited flexibility or institutional strength to tap alternate market-based sources of revenues.

- *Inability of local governments to fully realise the potential of own-source revenues:* Across all the cities studied, the pool of own-source revenues is insufficient (and inelastic) to meet rising expenditure needs. Most economically buoyant sources of revenues are retained at the national level. In the Asian context, octroi charge – which is a levy on the inflow of goods and services into a city – has been abolished on account of its regressive nature. Property taxes, licence fees from markets, shops and establishments, and user charges are some of the main sources of local revenues. However, local governments often lack the autonomy and incentive to establish their own tax base, rate structure and enforcement procedures. Furthermore, income from property tax is often well below its potential. This is on account of multiple factors, including the spread of informal settlements and slums that are not enumerated for taxation, outdated property records, valuations that do not reflect the current fair market value, poor collection efficiency and political issues.¹ To counter these factors, for example, as part of the Financial Recovery Action Plan, Kampala City Council is undertaking a slew of reform measures to increase its property tax revenues from an estimated US\$9.5 billion in 2007/08 to US\$12 billion by 2010.
- *Inadequate government transfers:* As a general trend, local governments continue to depend heavily on government transfers, whether from the public budget or donor aid on-lent by the central government. Most governments adopt a defined formula-based distribution of transfers, based on criteria such as population, land area, stage of development, poverty levels etc. These criteria are often considered inequitable and regressive by the larger urban local bodies, which contribute a significant percentage of the country's local government revenues. Also, in several countries, the extent and basis of central government transfers are neither stable nor transparent. More recently, some governments have introduced discretionary performance-based grants to reward progressive municipalities that have strong own-source revenues. For example, discretionary local government grants in Tanzania have been linked to municipal performance in key areas of financial management, participatory planning, and issues of transparency and accountability. On account of limited own-source revenues, local governments are forced to rely on the strength and predictability of fiscal transfers, particularly to plan any capital expenditure.
- *Limited resources for capital expenditure:* As evident from the case studies, recurrent expenditure, including personnel costs and establishment expenses, account for the majority of the municipal expenditure. For example, such costs amount to over 80 per cent of total municipal expenditure for Dar es Salaam and Kampala, leaving minimal resources available for growth-oriented development expenditure. For historical reasons, the bloated staff strength of municipalities and administrative inefficiencies have resulted in increasing

establishment expenses.² In light of this and revenue constraints, municipalities are often unable to ensure even the proper operation and maintenance of local infrastructure. Market interviews highlighted the gaps in the repair and rehabilitation of municipal infrastructure across the transport, water supply, health and education sectors. Therefore, there are typically limited resources available to invest in greenfield infrastructure projects, unless financed externally through donors or development finance institutions (DFIs).

- *Poor financial management*: Poor financial management further contributes to weaknesses in municipal finances. Many local governments do not have the capacity and technical expertise to establish a sound planning and budgeting process nor an up-to-date and transparent management reporting system. At the same time, few accounts are computerised and may require manual collation of financial data across the sub-national units responsible for collection. Therefore, data is often unreliable and outdated. In addition, few municipalities follow accrual-based double-entry accounting. Yet accurate reporting of revenues and expenditures of the municipality is a fundamental requirement to reliably reflect its financial position in order for it to access any market financing.
- *Nature of municipal infrastructure projects*: Affordability constraints and/or public health and social policy considerations may mean that users are not charged for the full cost of delivering certain municipal services. Typically, the potential for cost recovery through user charges is more difficult for municipal services. In many cases, municipal infrastructure projects either require an element of public subsidy (e.g. projects that involve delivery of sanitation services etc.) or are particularly ‘public good’ in nature (e.g. upgrading of urban roads or provision of street lights etc.). An essential condition for accessing and servicing market borrowing is that the project should be bankable or at the least have some revenue streams (e.g. high-demand toll roads and bridges and piped water supply to residential and commercial users). The particular challenge of developing such projects at the sub-national level presents an additional constraint.
- *Nascent development of financial markets*: Infrastructure requires a large quantum of long-tenor finance – either debt or equity. However, in most developing countries, even where the rate of savings is quite high (as in the case of most Asian countries), the financial intermediation of savings into productive investments is relatively nascent. The banking sector, which is typically more developed than the capital markets, is constrained by prudential regulations and asset-liability mismatches to finance long-term infrastructure. Moreover, potential long-term institutional segments such as pension funds, mutual funds and insurance companies, are only gradually

developing. Therefore, there are often supply-side constraints to overcome in tapping market financing.

As an illustration, local government per capita spending in developing countries vis-à-vis OECD countries highlight some of their financial constraints. The share of local government expenditure as a percentage of GDP for selected Commonwealth developing countries averages just 2.1 per cent, compared with the unweighted average of 21 OECD countries of 11.1 per cent. For example, while the average per person expenditure of local government in the UK was US\$2,798 in 2003, it was US\$107 in Uganda and only US\$18 in Tanzania.³

Measures to access alternate private financing for municipal infrastructure

With the limited financial resources available for long-term capital investments at the sub-national level, governments are becoming increasingly aware that private finance can form a considerable source of funding for infrastructure investments. In a number of emerging market countries, local government reforms like the restructuring of local government revenue sources, a greater autonomy to revise taxes, a transparent, predictable and formula-driven transfer system, as well as the deregulation of service provision have paved the way for local governments to mobilise domestic capital and harness the expertise of the private sector for infrastructure developments and service provision. Several cities, particularly in Asia, have tried to harness domestic private savings through intermediation in the credit and capital markets.

While there clearly needs to be caution in proposing local governments to take on debt and advocating private sector participation in service provision, it can provide local governments with strong incentives for improving project design, cost-recovery practices, budget transparency and financial management. However, empowering local governments to borrow requires effective regulation and financial controls to ensure overall fiscal discipline and stability. If managed effectively, it can have a beneficial ripple effect on the domestic financial markets and generate long-term financing for cities and their infrastructure agencies.

Chapter 7 illustrates some of the successful experiences in mobilising private financing and participation in the delivery of municipal services. Whilst there is no 'holy grail' to handle local government debt, there are some lessons to be derived from these successful examples with respect to the pre-requisites of developing local credit markets.

We classify these financial and institutional strengthening measures into 'fundamental' and 'credit enhancing' factors to enable alternate financing of municipal infrastructure. These factors are not exhaustive and focus on the 'demand-side'

issues that central and local governments need to put in place to mobilise private financing. To develop sustainable sources of private financing, these measures would need to be accompanied by the development of local financial markets.

'Fundamental' strengthening measures

As the name suggests, these measures are fundamental to improving the financial and institutional strength of local governments to mobilise private financing, and more importantly, to instil a sense of confidence in the market regarding the creditworthiness of local borrowing. A majority of these measures are required at the municipal level. Nonetheless, it is vital that the central government creates a suitable enabling environment to foster the growth of local credit markets and to encourage private sector participation. Some of the key fundamental strengthening measures are as follows:

- *Enabling policy environment*: Suitable central government policies and legislation often underpin the ability of municipal governments to borrow or contract with the private sector. For instance, the Vietnam government issued a decree to establish the Local Development Investment Funds as provincial legal mechanisms to develop growth-oriented infrastructure with private sector participation. Similarly, following the example of the US, the Indian government issued tax-free status to certain municipal bond issues to mobilise domestic saving for urban infrastructure financing.
- *Appropriate legal and regulatory regime*: Critical aspects of the enabling environment for local government borrowing/PSP include:
 - o financial prudence norms and bankruptcy laws to protect the interests of lenders,
 - o basic PPP or other laws, which inter alia define the roles of the contracting parties and those bodies required to approve any PSP investment,
 - o streamlined government arrangements which enable the speedy establishment of a financial intermediary or fund, or an infrastructure project special purpose vehicle or company, or the sanction of capital market issues, as required, and
 - o a truly impartial regulator, making decisions free from political pressure, or else a government commitment to back-stop any regulatory commitments so that any breach of contract would be protected against.

In the absence of a strong regulatory framework, private operators have to rely on the robustness of the contracts and their possible enforcement. This factor is usually the least developed link in developing countries, constraining participation of the private sector.

- *'Balanced' books at the municipal level:* A key deterrent to municipal borrowing is their inability to repay the debt on account of poor financial strength. As a minimum, municipalities should strive to 'balance' their books through a combination of revenue enhancement and cost containment measures. Particularly, municipal agencies seeking to issue general obligation bonds need to ensure that they can service the debts with their own revenues and/or allocated portions of the intergovernmental transfers. In order to derive comfort regarding the timely servicing of debt, lenders would typically assess the key financial ratios of the municipality such as its liquidity ratio, debt service coverage ratios, the overall surplus or deficit and collection efficiency of key own-source revenues.

Similarly, the assets and liabilities of the municipality should be systematically accounted for, including regular valuations to reflect fair market value. Often, physical assets such as land and buildings could act as security against borrowing.

- *Financial management and accounting reform:* Most municipalities that have accessed capital markets have transitioned to accrual-based double-entry accounting. This is important to understand the magnitude of the municipality's future liabilities and receivables. For example, the issue of municipal bonds by the Ahmedabad Municipal Corporation in the state of Gujarat in India was preceded by several financial management reforms to improve budgeting, accounting and overall financial reporting. This is also one of the considerations that credit rating agencies evaluate in rating a municipality or bond issue.

Another aspect of financial reform is to accurately account for the costs of the services that the municipalities deliver. Several local governments have outsourced the provision of selected municipal services such as the operation of local markets or bus terminals or street cleaning. However, in the absence of recording the actual costs of in-house delivery, these governments are unable to identify the financing savings as a result of outsourcing (these are of course in addition to any efficiency gains). Moreover, in the absence of proper accounting, local governments struggle to identify the appropriate price and performance terms at which they should award the outsourcing contract to the private operator and whether the tender represents value for money.

- *Structuring bankable projects:* Whilst the above enabling factors deal with reform at the municipality level, this factor focuses on developing commercially viable projects for private financing. One of the biggest challenges of accessing private finance for municipal infrastructure is that the projects are seldom revenue generating. Affordability and public/social goals impede charging for most municipal services on a cost-recovery basis. Given the

debt servicing demands of market borrowing (subject to the grace period), there is a high opportunity cost of not promptly deploying borrowed funds into projects that are ready for financing. Delays as a result of political pressures, or for example, land clearance issues, can be costly. As described in the case of the Tamil Nadu pooled financing, the bond was issued to finance water supply and sanitation projects that were already at construction stage or close to operation in order to ensure the speedy deployment of raised funds.

Even if the projects require subsidies, the subsidy element should be identified explicitly and structured as a separate stream of support to avoid distorting the financing structure. Typically, most municipal infrastructure projects require some element of concessional debt and/or grants or technical assistance to enhance their viability. For example, it has been found that 42 per cent of high-income countries are estimated to subsidise operations and maintenance costs of water provision for residential users (despite cross-subsidies between commercial and residential users).⁴

'Credit-enhancing' measures

Credit-enhancing measures may be adopted in addition to the 'fundamental' financial and institutional strengthening measures by governments, to enhance the creditworthiness (and to lower the risk) of the municipal agency. These measures are usually undertaken to increase market confidence amongst potential lenders to finance municipal units or projects and to improve the terms and conditions of financing. The fundamental premise of such risk-mitigation measures is to transfer certain defined risks from project financiers (debt or equity investors) to a creditworthy third party (guarantors, insurers) that has a better capacity to take on such defined risks. While these measures facilitate the mobilisation of private financing for infrastructure projects, it is important that the underlying borrower or project is adequately 'bankable' – otherwise, the providers of credit enhancements would be unable to properly assess the risks and offer (and indeed price) their risk cover.

The two typical credit-enhancing measures that have been adopted for attracting private capital at municipal level are obtaining credit ratings of borrowers/financing instruments, and purchasing risk mitigation/credit enhancement products.

- *Credit rating*: In cases where the issuing sub-national entity is strong or viable, it may choose to obtain a credit rating from a recognised international or local credit rating agency. Alternatively, particularly in the case of revenue bond issues – where the project is commercially self-sustaining – the bond instrument may be credit rated.⁵ Several urban local bodies have obtained a credit rating primarily to lower the cost of borrowing. Few investors have the specialist expertise or skills to evaluate the risks of a local government entity

or infrastructure project. For example, the purchasers of municipal bonds are likely to be pension, provident and mutual funds, and insurance companies, who are typically looking for long-term assets to match their long-term liabilities. Their main requirement, however, is that such assets are investment grade – both from a prudence perspective, but also because the institutions involved do not understand the underlying risks of the infrastructure investment. Therefore, it is particularly beneficial if the municipality and bonds in question are credit rated as investment grade by a reliable credit agency.

It is important to note that the costs associated with credit rating are often quite high and may not be affordable for the municipality. Those costs therefore need to be weighed against the opportunity cost of financing and the benefits of lower borrowing cost. In this regard, the technique of pooled financing could help to spread the costs of bond issuance across the urban local bodies in the pool, arguably making it more affordable.

- *Risk mitigation instruments such as guarantees or insurance:* In cases where the credit strength of the issuing agency needs to be enhanced or when it is a pioneering bond issue in a relatively undeveloped financial market, the bond issue may need to be backed by risk mitigation instruments in some way to attract subscription. There are several types of credit enhancements that are available, but the broad categories are based on:⁶
 - o Beneficiary of the guarantee or insurance contract: these may be debt providers facing credit risk, or equity investors facing investment risk and possible investment losses.
 - o Types or causes of risk: some risk-mitigation instruments such as partial risk guarantees differentiate between and cover only specific types of risk, such as political or commercial risk.
 - o Extent of loss coverage: this refers to the magnitude or percentage of debt service default or investment loss that is covered – i.e. whether full or 100 per cent coverage or lower.

In several cases, credit enhancement measures go hand in hand with and are, in fact, instrumental in obtaining a sound credit rating. For example, most of the bond issues (general obligation bonds, revenue bonds and pooled financing bonds) illustrated in chapter 7 had several layers of credit enhancement, including support from some risk-mitigation vehicles, which were key to their being assigned sound credit ratings.

Multilateral agencies like the World Bank/International Finance Corporation, Inter American Development Bank (IADB) and the Multilateral Investment Guarantee Agency (MIGA) offer guarantee or insurance products to specifically

cover sub-sovereign risk at state, provincial and municipal levels, subject to their credit assessments. Furthermore, private mono-line insurers also provide guarantees for municipal bonds in investment-grade developing countries. Again, the relative fee costs of a credit enhancement product need to be assessed vis-à-vis the benefits, such as potential crowding in of long-tenor lenders or extending the maturities of existing loans available.

Special purpose contingent finance vehicles such as LGUGC and FINDETER also aim to address the potential default risk associated with borrowing municipal agencies or projects. Their backing aims to increase the willingness of banks and other financial institutions to provide long-term finance for infrastructure projects.

Summary

Given the challenges of urban infrastructure financing, experience shows that market-based financing of municipal infrastructure in developing countries has so far been a small (although growing) proportion of the total investments.⁷ A key challenge is to lower the overall risk profile of the borrower or project. Many of the factors that can enhance the creditworthiness of the municipality are often beyond its control – these include the quantum and predictability of intergovernmental transfers, the national policies and regulatory environment, and the depth and breadth of local financial markets, amongst others.

Nonetheless, given the trends of fiscal decentralisation and the growing infrastructure financing gap, a more pragmatic and selective approach to shortlist avenues for private sector financing seems plausible. As a first step, this underscores the need for local governments to focus on the range of ‘fundamental’ strengthening measures proposed to make private financing a viable proposition. Furthermore, it is important to recognise that the remit of private financing extends primarily to commercial and financially sustainable investments and therefore cannot be considered the panacea of all urban infrastructure financing constraints. While private financing can never be a substitute for government funds, it can contribute, to a limited and defined degree, to the growth of the economy and to long-term investments in infrastructure and public services.

Notes

1. Where municipalities derive revenues from property tax and service charges, meaningful tariff increases are sometimes refused or delayed by central government for fear of eroding political support among the local population.
2. For example, some municipalities have on their payroll all the staff responsible for street cleaning and municipal waste collection. Other local governments have now outsourced some of these activities to specialised private sector/NGO operators, leading to cost-savings and improved management efficiency.

3. In US\$ at PPP.
4. Annez (2006).
5. The rating of the bond may be in addition to the issuing agency's credit rating. Clearly, the cost-benefit trade-off of obtaining each credit rating needs to be evaluated. Moreover, in instances, municipal bond issues (for example, in India) have obtained two independent ratings from different rating agencies to further enhance market confidence in the credit-worthiness of the issue.
6. PPIAF (2006).
7. Ibid.