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Insights from Practitioners' Conference on *Urban Infrastructure Finance in a Responsible Fiscal Framework: Lessons from Brazil, China, India, Poland, and South Africa;* Jaipur India, January 6-8, 2005

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Investment in urban infrastructure in developing countries is central to maintaining growth momentum and to ensuring the improvements in the quality of life that citizens expect as part of the development process. Sound fiscal management is not optional for sustainable long-term growth. Reconciling these two legitimate, but potentially competing objectives in a context of decentralization, has become a pressing—and challenging—policy issue for a wide range of the World Bank's clients. A conference held in India in 2005 examined how these issues are being resolved in Brazil, China, India, Poland, and South Africa. The conference sought to promote a dialog between investment financing perspectives that usually proceed in isolation from each other, while also generating a body of practical, transferable implementation experience. The presenters were primarily senior government officials and representatives of financial institutions, focusing on the experiences of practitioners in formulating and implementing policy. The cases featured included three of the world's largest decentralized nations; together the five countries featured in the conference account for nearly a third of the world's urban population. This note summarizes the insights gained from the conference and some of the issues it raises for further work in urban finance.

INTRODUCTION

Sound fiscal management is not optional for sustainable long-term growth. Adequate investment in urban infrastructure is central to maintaining growth momentum and to ensuring the improvements in the quality of life that citizens expect as part of the development process. Reconciling these two legitimate, but potentially competing objectives in a context of decentralization, has become a pressing—and challenging—policy issue for a wide range of the Bank's clients.

A conference held in Jaipur, India on January 6-8, 2005[1], examined how these issues are being resolved in Brazil, China, India, Poland, and South Africa. The conference sought to promote a dialog between investment financing perspectives that usually proceed in isolation from each other. The cases featured include three of the developing world's largest nations. They share a broad geographical scope and diverse and complex economies, and all are grappling with managing decentralization in different forms. South Africa and Poland, while far smaller, have experienced interesting economic and political transitions in which urban areas played an important role. Together the five countries featured in the conference account for nearly a third of the world's urban population.

A few key initial insights, worthy of further debate and validation that emerged from the discussions:

<u>The fiscal risks of decentralization are real, but manageable.</u> Experience in South Africa and Poland illustrate that it is possible to devolve substantial responsibilities and resources to local governments in risky environments without creating long-term macroeconomic problems. Achieving this result usually requires an iterative process, and second generation reforms are not necessarily a sign of failure,

[1] Organized by TUDUR and SASEI, in collaboration with PREM, the Caixa Econômica Federal of Brazil, the Infrastructure Development Finance Corporation of India, USAID, the National Institute of Urban Affairs of India, DFID (the UK Department for International Development), PPIAF (Public Private Infrastructure Advisory Facility), the Council of Europe Development Bank, and co-hosted by the Ministry of Finance, Government of India and the Government of Rajasthan, this seminar was sponsored not only by international donors, but also by developing country financial institutions.

and may be a healthy adaptation. On the other hand, both the Brazilian and the Indian experience illustrate in different ways that controlling local governments to avoid risks may involve substantial costs. While China has achieved an impressive record of investments in certain cities, its experience nonetheless indicates a need to manage the inter-governmental framework carefully in the decentralization process.

Neither reforming the financial sector nor eliminating soft money for municipalities are alone sufficient to ensure that municipal governments will successfully tap private capital markets. Municipalities need to have a minimum threshold of functional responsibility and revenue generation capacity, and credible municipal accounting, reporting, and auditing rules are required to provide comfort to the private sector. Even private intermediaries need strong support in the start-up stage to build the business of municipal lending, and clear rules regarding municipal bailouts are key. These factors are significant in both the Polish and South African successes and in the disappointing performance of India's cities in tapping funding for infrastructure from a financial sector that is exceptional for its depth of intermediation and scope of financial services provided.

Municipal assets, especially public lands, can be used successfully to finance infrastructure development, either through direct sales or as collateral, and are often underused. In Poland after the transition, and in Shanghai, this approach was adopted successfully. There are risks, especially in the collateralization approach, and the aggressive methods used in Shanghai are not likely to be replicable in other contexts. Nonetheless, countries such as India possess massively underused land assets, whose potential value should be unlocked for infrastructure finance.

Private investment in local infrastructure remains a hope in most countries, but one whose performance thus far has lagged well behind expectations. Discussions indicated that the high hopes placed on private-public participation (PPP) as a substantial alternative source of funding urban infrastructure may well be misplaced. Very rarely have all the necessary conditions for reducing private sector risk to manageable levels been assembled. One of the key issues is, of course, household tariff rates, which are broadly subsidized in most places; specific cases of Brazil, China, and India were discussed here. It is only in those cases where an alternative source of funding is available, be it other municipal revenues or cross subsidization from captive industrial users, that the necessary revenue base to attract private financing is achieved.

RECONCILING FISCAL DISCIPLINE AND SUB-NATIONAL INFRASTRUCTURE NEEDS

Intergovernmental rules such as the Fiscal Responsibility Law are one means of achieving fiscal discipline at the sub-national level, although the Brazil case shows these can be something of a blunt-edged tool. Indeed, the sub-national debt problem was focused in just a few major cities and states. Seventy percent of municipal debt, for instance, is accounted for by three cities. Yet the safeguards in place today—central bank prohibitions on municipal bond issues and balance sheet limitations on financial intermediary exposure to sub-national borrowers, are so stringent that there is virtually no flexibility for creditworthy municipalities to tap financial markets. The conference discussed cases where the workings of financial markets were used as a complement to government rules to impose discipline on sub-national borrowing, as in the case of South Africa. While financial systems may have tremendous capacity and depth, as is the case in India, the scope for their involvement in cities will remain limited as long as the revenue base is not adequate for debt service at reasonable levels. The share of GDP spent by Indian cities—on the order of 0.6 percent and unchanged in the twelve years since decentralization commenced—remains a small fraction of the levels realized in the other countries, and infrastructure service gaps in cities have increased in spite of solid economic growth over the period.

One Indian presenter from the Ministry of Finance discussed the common view in India that expanding revenues and autonomy for local governments should take place only after they have proven their capacity and ability to undertake a more significant role. By contrast, in both Poland and South Africa, during far-reaching economic and political transitions fraught with unknowns and risks, municipalities were given an important role as drivers of development before they had proven themselves. In both cases, changing the roles of municipalities was a key element in creating more accountable, democratic governance, and thus part of a broader political process. Both functional responsibilities and revenue sources were adapted in Poland as problems arose,

but, in addition, binding "failsafe" constraints were also placed on the indebtedness of individual cities and on aggregate municipal debt. In South Africa, similar process adjustments and revisions were necessary as reform proceeded, but from the beginning, central government guarantees of local borrowing were prohibited. A well-developed financial sector and a strong local government accounting system at the time of decentralization also facilitated reliance on financial markets to promote fiscal discipline.

The current environment in Brazil is dominated by the continuing adjustment process, the rigidities imposed by the wage bill expansion in the 90's, and the earmarking introduced in the 1988 Constitution. While the constitution provides a steady revenue stream to cities, large portions of those revenues are earmarked for social expenditure, and tapping local capital markets is severely constrained. The resulting inflexibility penalizes spending on infrastructure. Two important questions emerge in this tightly constrained environment: 1) while adjustment for Brazil will necessarily be a long-term process—can the current constraints be sustained? 2) Over the long term, what are the costs to the economy of the inefficiencies imposed by constraints that work strongly, even if unintentionally, against investments in infrastructure while driving large amounts of money into the social sectors, and can they be mitigated?

In China, decentralization was seen as inevitable in the transition to a market economy, and in this regard, was remarkably successful. Shanghai's no less than spectacular results in transforming their urban infrastructure, however, are far from representative. While some cities such as Shanghai tapped multiple sources of finance in a growing economy, including reliance on monetizing the value of land assets, others have not fared so well. Some practices, in particular collateralization on the basis of future land values, represent a potential risk to the financial system. Tighter regulations are reining in these practices; and combined with reform of the financial system, they should strengthen further the infrastructure financing framework. The lessons from China are significant, but nuanced. Decentralization and local autonomy work, as they promote competition among cities and better accountability for service provision; but they work only within a functioning inter-governmental fiscal system, clarity on the rules for local action, transparent financing, and rational incentives and institutions to enforce accountability.

MOBILIZING FINANCE FOR URBAN INFRASTRUCTURE INVESTMENT

This session examined alternatives for generating capital financing for urban infrastructure, given the special conditions of each country, and the extent to which successes in one nation carried lessons for others.

Borrowing from the private sector. Much of the discussion addressed the potential for tapping private savings for investment in urban infrastructure. Participants agreed that, though financial engineering could improve the efficiency of intermediation between private savers and local government borrowers, significant progress in accessing private savings could be made only if local governments had substantial, secure revenue streams that they could pledge for debt repayment. The countries that have managed to mobilize large volumes of savings from the private market—Poland, South Africa, and China—share the characteristic of having clearly identified and substantial local revenues. Borrowing to finance infrastructure, without adequate capacity to service debt, only generates future fiscal crises.

The value added of private sector involvement in intermediary institutions financing infrastructure investment is an important related issue. Experience ranged from a 100% privately-owned infrastructure fund in South Africa (INCA) to private management and minority private equity in a public infra-structure fund in Tamil Nadu (TNUDF), and the transition of borrowing by Polish municipalities from a public environmental fund to borrowing from private banks. The consensus was that the discipline of the private market should be introduced as fully as possible to local infrastructure borrowing, but that the feasibility of privatization of the local credit market depended upon the history of financial sector development of each country. In TNUDF's case, for example, private management in allocating loan resources according to market principles might well be more important than private ownership of the lending institution. Polish and South African participants emphasized certain key characteristics that private sector lenders could provide—namely, fast response time, non-political allocation of resources, insistence on

loan repayment and the discipline that implied, and careful financial monitoring that helped municipal borrowers identify and resolve financial problems at an early stage.

Private sector investment in urban infrastructure. Private investment in local infrastructure remains a hope in most countries, but one whose performance lags well behind expectations. The individual examples in all five countries that were discussed each relied on special local circumstances that will rarely occur elsewhere. Private investment in urban infrastructure is attracted by a tariff regime that permits full cost recovery, including an adequate return on invested capital, and as little exposure to political risk as possible. At present, these conditions are most likely to be met in circumstances where very large cross-subsidization from well-off industrial and commercial users can be implemented, and these necessary conditions are found infrequently. Workshop participants noted the apparent inconsistency between the high hopes being placed on private investment (as exemplified by Brazil's recent public-private partnership law) and the track record of the past six years.

Converting other state-owned assets into infrastructure. Discussion brought out the extent to which local infrastructure investment in Shanghai, and China generally, has been financed by the sale of traditional state-owned assets—municipal enterprises of different types, but principally municipally-owned land. These assets were either sold, with the proceeds invested in infrastructure, or were used as collateral for balance-sheet borrowing to finance infrastructure projects. The heavy reliance on increasing land values carried risks for the financial system as the viability of bank loans became dependent upon continuance of a strong land market. In other countries, particularly India, the public sector held very valuable urban land parcels that were institutionally managed outside any market framework. Converting publicly-owned urban land to cash could provide a significant boost to infrastructure finance.

RECOVERING CAPITAL COSTS FOR URBAN INFRASTRUCTURE AND SERVICES

For those infrastructure services amenable to individual charges, cost recovery can be a powerful tool in securing revenue streams to service loans. The panel discussion featured three different experiences focusing primarily on urban water provision: São Paulo state in Brazil, Shanghai, and India.

In China, the national government has shown leadership on the issue by announcing a policy of full cost recovery, with targets for phasing in the transition. Implementation varies across local governments, and those with ample resources have funded subsidies to ease the transition. For example, cost recovery in Shanghai is significantly lower than other cities including Beijing. Shanghai's strategy features (i) conducting public hearings on levying or increasing user charges, (ii) providing direct lump-sum support to the low-income groups to ensure a minimum standard of living taking into account the cost of the consumption bundle, and (iii) containing costs by regulating service providers, enforcing competitive bidding, and setting performance standards.

The constraints to cost recovery in India include, among others, a significant gap between "willingness to pay" and "willingness to charge". The discussion raised the issue of fragmented governance of urban service delivery (water being a serious case in point). Local governments with limited revenues and control over investments are typically in no position to take potentially costly political positions to improve services and raise tariffs. The case study on the Tirupur Water Supply project, the first private provision of water supply in India, presently under construction, illustrates some of these issues and one attempt to overcome them. This project took ten years to negotiate, in spite of a pressing and well-articulated demand for water from textile exporters with ample willingness to pay. The project will seek to combine more efficient service delivery with user charges that strongly subsidize residential consumers, cross-subsidized by high industrial rates. These rates are considered viable given the premium these exporters place on plentiful and reliable water supply. Given the complexity of the financial structure, the time it took to prepare, and the particularities of Tirupur's industrial base, participants questioned whether this project, even if it operates successfully, illustrates a replicable solution for providing better water services or underscores weaknesses that must be addressed in the Indian environment.

The Brazil presentation discussed the role and limitations of cost recovery in a tightly constrained fiscal environment. It pointed out the limited budgetary flexibility remaining in São Paulo state, once debt service requirements (about 13% of total revenues)

constitutional earmarking for education (30%) and health (12%) are taken into account. Cost recovery discipline is thus essential to providing for further investment in infrastructure. SABESP, a water supply parastatal servicing 65% of the state of São Paulo's water market through concession agreements with municipalities, has fully recovered operating costs for some time, and taps private capital markets, including the New York Stock Exchange. Arguably, SABESP could mobilize more on private capital markets were it not for borrowing restrictions it faces due to government limits on parastatal borrowing.

SABESP achieves this result through cross subsidies from industrial users to all residential consumers, who are subsidized across the board. (South Africa has also funded a substantial subsidy to residential water users using cross subsidies.) However, the viability of cross subsidization over the long term is questionable, as the industrial user base erodes as a result of price sensitivity, even in the relatively low-cost Brazilian environment. It is also of interest to note the tenacity of very broad-based subsidies for residential users. In spite of tight fiscal restraints, all residential users in the richest state in a middle-income country benefit from what is likely to be a dwindling cross-subsidy base from industry. The situation for other sectors is not nearly as good, as the figures presented on two mass transit companies illustrated. The presenter argued that even if there is a strong economic case for subsidizing mass transit, the massive subsidies required by these companies crowd out funds for further investment.

CONCLUDING THOUGHTS

The conference generated insights that can help us frame operational approaches. While decentralization complicates fiscal management, the risks are manageable; measures such as strong accounting and transparency, prohibitions of guarantees from higher levels of government, and avoiding excessive fragmentation of local governments are instrumental in doing this. Repressing the financial sector has important costs, since financial intermediation appears a more promising channel for financing municipal infrastructure than direct private investment in urban infrastructure facilities. The latter has not lived up to expectations, partly because it has proven difficult to design schemes for sharing risks of urban service delivery between the public sector and private investors and to establish user charges acceptable to government, users, and investors. Finally, endowing local governments with assets such as land, and allowing them to use them as a means of finance, while not without its pitfalls, can open up financing opportunities.

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