Accessing Private Domestic Financing to Improve the Delivery of Urban Services

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Introduction

U.N. Habitat estimates that the total investment needed for municipal infrastructure and to achieve the Strategic Development Goals (SDGs) over the next decade is about $38 trillion, but the current level of investment is only about $32 trillion. The resulting municipal infrastructure financing gap of approximately $6 trillion exceeds the capacity of central and local governments and their development partners. Unless municipalities identify alternative sources of financing, they will not be able to meet the SDGs and provide critical services being demanded by residents.[1]

At Chemonics, we believe that efforts must be made to increase investment from the private sector to close this financing gap. With our partner, FEI Consulting, LLC, we have prepared this paper to highlight the infrastructure financing gap and the essential role the private sector can play in improving delivery of urban services. Further, our paper presents specific lessons learned that governments can use to attract these private investors and improve the operational and financial performance of their municipalities.

Closing the Municipal Infrastructure Financing Gap

The world's urban population is growing at a breakneck pace that will result in 80-90 percent of all people living in cities by the end of the 21st century.[2] This unprecedented scale of urbanization will require large-scale urban infrastructure financing so that municipal governments can meet rapidly increasing demand for services such as water supply and sanitation, solid waste removal, better transportation, drainage, and street lighting. With these needs in mind, t

The U.S. Agency for International Development (USAID) has developed a Strategy for Financing Self-Reliance (FSR) as part of its new approach to help partner countries on their Journey to Self-Reliance (J2SR) and eliminate the need for foreign assistance. The FSR strategy emphasizes a country's capacity for self-reliance and its ability to plan, finance, and implement its own development solutions. The FSR focuses on the strengthening of public, private, and civil society entities to mobilize and transparently manage financial resources to achieve agreed-upon development objectives. Through this strategy, USAID proposes, among other things, to create conditions under which the private sector can operate public services effectively and financial markets can effectively mobilize domestic and international financing for cities. One clear outcome of the FSR is that strengthening the capacity and improving the performance of municipalities will help urban centers gain access to private financial resources, closing the municipal infrastructure financing gap. An additional and equally important outcome of the FSR is the development of the domestic financial community and the strengthening of domestic capital markets.[3]

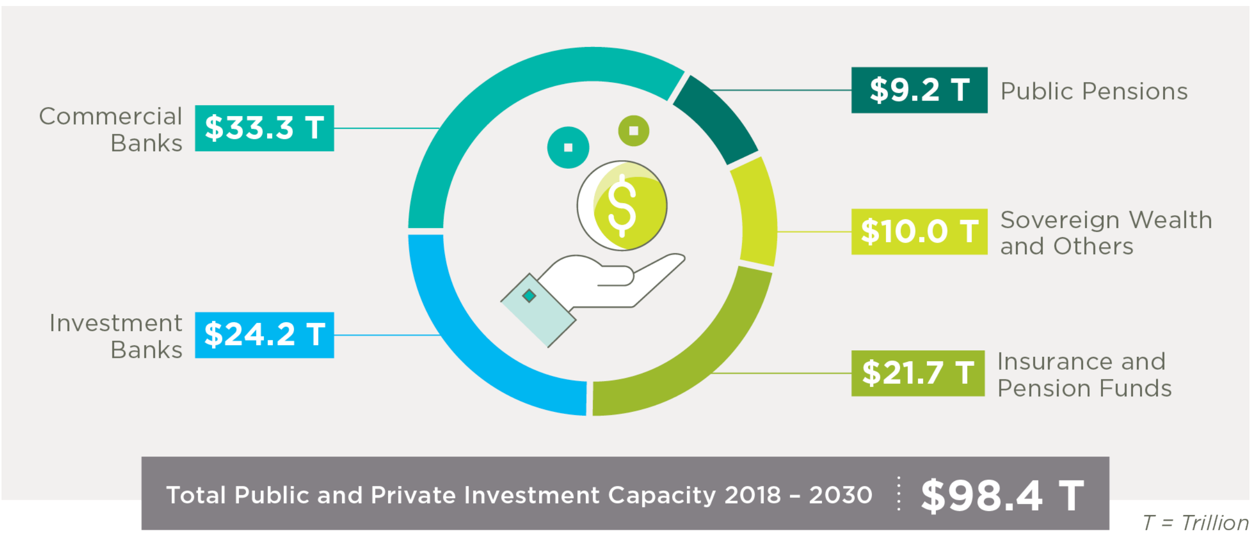
While the data suggests that FSR is essential, the importance of accessing domestic financial resources does not receive sufficient emphasis. Since virtually all revenues received by municipalities are in local currency, financing needed infrastructure through international sources may result in municipalities

[1] Financing Sustainable Urbanization, U.N. Habitat, February 2020
[2] Innovative Urban Financing can make our Cities Stronger, World Economic Forum, March 2019
[3] U.S. Agency for International Development, Strategy for Financing Self-Reliance

incurring a significant foreign exchange risk. This is another reason more emphasis needs to be directed toward developing and attracting domestic sources of financing to enable municipalities to close the infrastructure financing gap.

Developing estimates of the worldwide municipal infrastructure financing gap and the amount of available private financing resources is difficult and estimates vary, but U.N. Habitat has estimated that the total investment capacity of the public and private sectors over the period of 2018-2030 to be about $98 trillion (see Figure 1). Since the estimated infrastructure investment gap is about $5.8 trillion over the same period, we believe that the J2SR strategy to mobilize domestic and international financing to cities is realistic. However, it is important to note that financial resources available to cities in Africa and Asia are limited, as their domestic capital markets are still developing. This municipal infrastructure financing gap

Figure 1. Total Public and Private Investment Capacity[4]



offers an unprecedented investment opportunity for private investors, but municipalities need to develop capital investment plans for financially viable projects which would be seen by the investment community as being bankable (see box).

Bankable Project

A project is bankable when it is able to generate sufficient cash flows to meet obligations created during capital outlay. Bankable projects can enable financiers to lock-in medium to long-term assets to offset their corresponding long-term liabilities. The inability of municipalities to identify and develop bankable projects is a critical issue.

From the data presented, it is clear that a municipal infrastructure financing gap exists, and that the financial community has the capacity and the self-interest to close that gap. A critical issue to be addressed in attracting this financing is presented in the box below. Some additional issues to be addressed include: *What has prevented this potentially mutually beneficial relationship from developing? How can municipal governments, perhaps with the support of their development partners, attract some of this available financing to provide the urban services their*

[4] Financing Sustainable Urbanization, U.N. Habitat

populace demands? How to increase the level of commitment on the part of government officials to increase the use of commercial financing to improve the delivery of sustainable services?

Attracting Private Sector Financing

Private sector financing offers several advantages. In addition to capital, the private sector has the capacity to provide project management experience, which increases the likelihood that deadlines are met and cost overruns are minimized. The private sector is also more likely to develop projects with commercial potential and with workable economic structures. Private sector participation can also provide a "signaling" effect, attracting additional private sector investment.

However, while it is clear that municipalities need private investors to close the financing gap, these investors perceive significant risks in providing long-term financing to municipalities, particularly in emerging markets. To attract them to the municipal sector, central and local governments need to work with these financiers to understand their perception of risks and design measures to mitigate those risks.[5] Some of the key risks in investing in municipalities include:

Critical Issue in Bridging Financing Gap

Governments, municipal officials, and development agencies do not understand commercial financing and the actions they must take to attract (crowd-in) the private sector to finance infrastructure in municipalities in developing countries.

- Political instability
- Corruption
- Weak and/or complex legal framework
- Limited institutional capacity
- Credit risk — the inability of service providers to generate a reliable operational cash flow
- Climate change (increases the complexity in developing urban plans)
- Limited commitment from senior officials

Risk mitigation can and should be used to address and reduce specific risks to attract private investors to the sector. Different types of risk mitigation are necessary at different stages in the investment process. The process can be divided into three common stages:

- Foundational – developing creditworthy entities
- Pre-default – leveraging public sector funds, blended finance
- Post-default – considering the level of risk to the private investors

Each of these dimensions of risk mitigation should be carefully conceived and properly understood. The first risk mitigation stage, *foundational*, requires the development of creditworthy municipalities or, at the very least, a demonstrated commitment to that objective. In the box below, we present detail on what it takes to be regarded as creditworthy. Unless an entity is at least marginally creditworthy or can demonstrate progress toward that objective, it will be difficult to encourage private investors to provide

[5] Mobilizing private finance for sustainable infrastructure, Global Economy and Development at Brookings, Sept 2017.

needed funds. The creditworthiness of a municipality is viewed as a foundational risk mitigation factor, as it is one of the most important concerns for the private sector in considering financing for municipalities.

The second risk mitigation stage discussed here as *pre-default* requires the development of a robust and transparent enabling environment. The enabling environment refers to the economic, social, and political context in which a business operates. The environment includes national sector policies, which are critical levers when looking at how to attract more private investment for municipal infrastructure. Additional private sector concerns to be mitigated include political instability/risk, risk presented by corruption, weak or complex legal frameworks, a lack of contractual enforcement, and low counterpart quality. Governments must prioritize improvement of the enabling policy and legal framework in host countries to catalyze more private investment in municipalities.[6]

The enabling environment also includes the ability of local governments to have effective municipal finance capacity. Municipalities need the ability — and the willingness — to implement appropriate tariff policies and user charges to ensure that the services they provide are financially sustainable. One of the major risks perceived by private sector investors in lending to local government entities is that they will not be repaid. Municipal governments can greatly reduce this risk if they can demonstrate that they are financially sustainable and moving to becoming creditworthy. As the box above (page 3) explains, being creditworthy requires a reliable stream of positive cash flows and financial reports that demonstrate the entity's ability to fully recover operating expenses from revenues.

In the third mitigating stage of *post-default*, priority should be given to strengthening the capacity of local institutions and implementing robust national policies and procedures. These actions are critical to attracting international and domestic private financing, along with developing domestic capital markets. Central governments need to design programs to enable domestic financiers to lend/invest in long-term economic assets in municipalities. Enabling municipalities to become more creditworthy also impacts the availability of private financing by demonstrating to the investors that lending to municipalities is a potentially profitable business segment.

What Makes an Entity Creditworthy?

Creditworthiness is a measure of a borrower's ability and willingness to service its debt obligations. To be creditworthy, an entity must show a reliable stream of positive cash flow from its operations and have sufficient cash reserves in the case that future cash flows are not sufficient. The determination of creditworthiness is based on an entity's total activities and not merely an individual project. The level of creditworthiness is determined through a valuation performed by lenders and independent parties.

Domestic investors are important not only because of the lack of foreign currency risks, but because they are more knowledgeable about the political and policy risks in the country. Since these domestic financiers have a presence in the national and local markets, they are able to have a positive influence on the governance framework. In addition, loans that improve the capacity of municipalities to deliver sustainable services will also have a positive impact on local businesses and increase their demand for financing. Effective ways to strengthen domestic financial capacity include the removal of policies and regulations that restrict investment, and the creation of

[6] Ibid.

opportunities for local companies. Longer-term efforts should also be invested in developing domestic capital markets that would be better able to channel domestic finance and local investments.[7]

Capacity and Commitment

If municipalities are to attract private sector financing, they must make consistent efforts to address the wide range of capacity issues described in the preceding section. Overcoming the perceived risks associated with financing municipal infrastructure also requires a clear and consistent commitment from central and local government officials. Without this commitment, sustainable institutional reform and capacity building is unlikely.

USAID's J2SR assessment takes an objective look at a country's capacity and commitment levels to assess the current environment and the progress being made toward becoming self-reliant. It is also used to establish a dialogue with a wide range of key stakeholders and development partners. Its twin concepts of capacity and commitment assessment allow development partners to evaluate a government's determination to make complex decisions to improve the level and quality of services being provided.[8]

The tenants of commitment in USAID's Policy Framework are **effectiveness**, **inclusivity,** and **accountability**. In the context of FSR, these values can serve as a lens for understanding how — and how well — local actors mobilize and deploy financial resources to support sustainable development outcomes. Examining the political economy dynamics of FSR within local systems helps us to identify factors that influence commitment and where there might be opportunities to engage. As seen on the USAID/Chemonics Tunisia Fiscal Reform for a Strong Tunisia (FIRST) project, using analysis of political dynamics and governmental commitment to reform state financial policies facilitates the tailoring of assistance for meaningful change. FIRST conducted an applied political economy analysis (APEA) to better understand the context, including key advocates of specific fiscal reforms, those opposed to specific fiscal reforms, and those who were indifferent. The APEA allowed the project to think and work politically by prioritizing the reforms for which there was little opposition and to devise strategies to advance the reforms for which there was opposition.

Developing Bankable Projects and Attracting Private Investors

An additional concern of private investors is the lack of a pipeline of bankable projects. Too often, municipalities play a passive role in project design. Since they are dependent on central governments and their development partners for most of their capital or development budgets, they often wait for those entities to indicate what projects they are willing to finance. Local governments need to become more active in identifying development projects, in conjunction with their residents and community groups, that address the need for improved services that the residents are willing and able to pay for. Municipalities

[7] Ibid.
[8] https://selfreliance.usaid.gov/

should include these projects in multi-year capital investment plans that provide links between the municipality's strategic vision, its urban land use plan, and its annual budget. The U.S.-based Center for International Private Enterprise (CIPE) has one such methodology through which local governments can systematically interact with and gather feedback from local communities, which has been employed to significant effect in the Philippines.[9]

In addition to presenting the municipalities with a proposed pipeline of development projects, the capital investment plan would typically identify potential sources of financing for these projects. Public funds, including those provided from development partners, could be allocated to finance projects which would have limited opportunities for self-financing such as drainage works, local roads, housing, and street lighting, while identifying economic projects such as household water connections, local markets, and commercial facilities to be financed by private investors.

Teams on projects that are expected to be financially viable should meet with the private investors to understand their concerns and their potential interest in participating in the financing. After listening to the financiers, the municipal government can decide what, if any, actions it should take to increase the financial viability of the projects to make them more attractive to investors. Actions to be considered include reducing some of the project preparation costs by transferring those costs to the municipality, municipality-financed environmental work and resettlement expenses, and the provision of low or no cost loans to the project. These activities, known as viability gap financing, can make an economically viable project also financially viable and bankable.

Leveraging Public Fiscal Resources to Attract Private Sector Financing Risk Mitigation and Creditworthiness

Governments, central and local, should use their limited public fiscal resources to leverage the additional financing that private investors can provide. Municipalities need to first understand the perceptions of investors both with regard to the bankability of a particular project but also the broader issue of the perceived risks associated with lending to municipalities in general and to a specific municipality. Once the municipal management has this information, plans can then be developed to mitigate those risks/concerns in order to attract — or crowd-in — the investors rather than to crowd them out with low or no cost public financing. The leveraging effect of public resources can be significant in reducing the risks and attracting private financiers, but to maximize its effectiveness it must be done in collaboration with the private sector and the local community groups.

USAID and other development partners can have a significant role in enabling municipalities to mitigate identified risks. This support can take many forms, including providing needed capacity building to the various entities, offering input on improving the government's sectoral policies and institutional capacities,

[9] https://www.cipe.org/resources/the-performance-governance-system-in-the-philippines-building-the-capacity-of-local-institutions/

and proposing measures to strengthen the domestic capital markets. The capacity building can also support ongoing efforts to improve the financial viability of selected municipalities to enable them to become more creditworthy. Municipalities that address creditworthiness will minimize a major risk factor for private investors.

Development partners can also help municipalities use project financing for those projects which have the potential to be financially viable. The private sector would be far more likely to invest in a project with the potential to create a reliable cash flow stream that is secure from other government creditors and therefore likely to guarantee loan repayment and return on investment. By pursuing private sector financing for those financially viable projects, municipalities can then focus their limited public funds on projects which are socially important with high economic benefits but limited in their potential to generate positive cash flow.

Development partners can support governments on other risk mitigation measures which would have a positive impact on attracting — or crowding-in — the private sector, but perhaps one of the most powerful tools available is the use of blended finance. **Blended finance** refers to the use or blending of low-cost, long-term public financing with market-based private financing. It combines grants with loans and other risk-sharing mechanisms such as debt reserve funds, enabling municipalities to leverage their contributions to attract the additional private financing that municipalities need to close their municipal infrastructure financing gap. One of the main benefits of blended finance is its flexibility, as it can be adapted to address the identified risks facing a particular municipality. Experience with blended finance has shown that the ratio of public to private financing in a specific transaction can evolve over time as markets develop and as investors become more comfortable with the municipal sector.[10]

Conclusions and Recommendations

The expected rapid growth of cities large and small will result in demand for more and higher quality services, and to satisfy that demand municipalities must increase their investment in infrastructure and properly maintain that infrastructure. Given the limited public fiscal resources, only private sector financing can address the municipal infrastructure financing gap. The resources available to the private sector are significant and, in many cases, these investors are looking for new markets that can provide them with investment opportunities that more closely match their long-term liabilities. In short, the private sector, whether as an operator under a public-private partnership or as an investor, must make a profit and ensure that the expected return reflects the estimated level of risk (see box).

Mobilizing the Private Sector

The private sector's primary concern is to make a reasonable profit in relation to the risks undertaken. This implies that the risk-reward for the private sector must be in balance.

Government officials must be committed to decision-making that will improve the operating and financial efficiency of the operating entities and indicates consideration of long-term viability. Below are several

[10] Easing the Transition to Commercial Finance and Sustainable Water and Sanitation, World Bank, August 2017.

recommendations from bankers and development professionals on how best to support municipal officials to build commitment to meaningful reforms, innovative thinking, and sustainable growth.

- **Improve Municipal Financial Planning –** Banks in developing countries operate primarily on short-term deposits; as a result, the long-term lending capacity which is required for infrastructure is limited. Furthermore, municipal officials are more concerned with ribbon-cutting for new infrastructure than properly managing and maintaining their existing assets. To change these dynamics, municipalities need to develop more inclusive rolling capital investment plans that build local ownership and autonomy, and municipal officials should emphasize the importance of creditworthiness. The bankable projects which emerge from these investment plans should correspond to the needs of local investors. Municipal officials will need support to develop and inform investors and communities about these new investment plans that prioritize long-term planning.
- **Pursue Blended Financing** – Municipalities have limited sources of revenues, which limits their debt service capacity. To maximize the reach of often limited municipal revenue sources — typically confined to trade services and property taxes — public funds should be used to attract and leverage commercial funds. Prioritization should be placed on building municipal officials' commitment to sustainable services and improving infrastructure.
- **Increase Emphasis on Cash Flows** – Municipal infrastructure provides the domestic financial community with a huge new market for long-term investments, but to access this market the financiers will need to change their investing philosophy. Since municipalities do not have assets which can be used as collateral for new lending, investors and governments need to emphasize a preference for projects with sustainable operational cash flow potential that can be used to pay the cost of debt service, rather than depending on more traditional lending that relies on collateral. They can use other tools on an as-needed basis to further mitigate perceived credit risks, such as debt service reserves and loan guarantees. Both governments and domestic financiers will need support to achieve this shift in lending philosophy and develop the needed capacities.

USAID and other development partners have the capacity to support central and local governments to leverage their limited public funds to mitigate the risks perceived by the private sector — and thus to crowd-in private domestic investors. These partners also have the capacity to assess the level of long-term commitment to sustainable reforms, using tools such as APEA and other resources to facilitate thinking and working politically. They have the technical and financial resources to strengthen the government's sectoral policies and institutional capacity and support efforts to enable domestic financiers to increase investment in municipalities. Too often however, central and municipal officials and development agencies do not understand commercial financing and the actions that must be taken to attract the private sector to finance infrastructure in municipalities in developing countries. Furthermore, development agencies often find it easier and faster to proceed with traditional grant financing rather than trying to crowd-in domestic private investors.

With the support of development agencies such as USAID and commitments from central and municipal officials, governments can close the current infrastructure financing gap by crowding-in domestic and international private investors. This support will result in more financially viable cities that are able to incubate new companies and create jobs for the growing urban population and deliver sustainable urban services.