

Fourth World Water Forum

Cross Cutting Perspective 1: Innovative Models for Financing Local Activities

Baseline document

Discussion Draft

presented at Beacon Meeting, Mexico City, 24-25, February 2005.

Beacon Note

Cross cutting perspective A: Innovative Financing Mechanisms for Local Action

A cross cutting perspective on innovative financing mechanisms for local action has been provided by the Task Force on Financing Water for All. This Task Force under the chairmanship of Sr. Angel Gurria, Former minister of Finance of Mexico and the incoming Secretary General of the OECD, has been considering financing water for local governments, financing water for agriculture and progress made on innovations in financing mechanisms since the 3rd World Water Forum in Kyoto. The findings of the Task Force and its Working Group on Agriculture are to be published in two separate reports also available at the 4th World Water Forum.

The following is a summary of some of the general issues related to finance and local action.

Developments since the 3rd World Water Forum

Since the presentation of the Camdessus report during the 3rd World Water Forum in Kyoto (2003) it is common for all parties to measure their achievements against the yardstick of the Millennium Development Goals. Progress is monitored by the UN (including the Secretary-General's Advisory Board on WSS) and some independent networks. Interlinking these monitoring efforts is initiated through a Water Monitoring Alliance launched by the WWC.

Substantial progress has been made in sub-sovereign financing, which has moved high up the agenda of discussion. Leading multilateral financing institutions (MFIs) have reviewed their policies and practices in this regard. Though more instruments are now available, the scope for sub-sovereign finance is still limited. In some cases this is due to host government resistance, the specific risks of working at this level, and the lack of capacity of local governments to prepare, manage and implement projects. Much more attention is now paid to adapting financing mechanisms to deliver water services to poor target groups.

Generating the amount of money required to meet the MDGs means roughly doubling all funds from all sources: revenues from users, government contributions, MFI loans, aid donor finance, commercial loans, private equity, NGO funds, etc. However, maintaining even current investment levels, let alone doubling them, represents a daunting challenge in the face of constrained public resources and aid flows. ODA is slightly recovering after the share of water in bilateral ODA had actually declined from about 5.4% to 4.2% over the period 2000-2004, despite an overall rise in total aid and the appearance of new dedicated water facilities (e.g. ACP-EU Water Facility, African Water Facility). The recent commitments of doubling the ODA by the G8 during their 2005 summit in Gleneagles and the initiatives of some bilateral donors augur well for a rise in ODA for water. ODA however represents only a small amount of the needs but plays an important role in leveraging other money. Donors are encouraged to increase this leverage effect as much as possible.

New kinds of private sector participation are emerging. Private equity investments in water have reduced. Large multinational companies have in general retreated from new major concessions, but in their place a variety of smaller companies, including locally based operators, have appeared taking a more affermage and management type of contracts and not bringing major investments.

Although decentralisation is occurring in many countries, there are still blockages in the flows of budgeted allocations from central governments to the local entities responsible for extending water services, leading to widespread under-spending.

Recommendations to Enhance Access to Finance – Innovative Financing Mechanisms for Local Action

The management and provision of water services is largely a local responsibility. Financing Local Action is an essential part of the local capacity to develop and manage water related services in a sustainable way. Finance depends on repayment capacity, which ultimately derives from the direct contributions of users and indirect contributions from taxpayers (subsidies). This is valid at all levels, from grass roots to national investments.

Enhancing access to finance requires

- (i) local and national governments to recognise that loans for investments have to be paid back;
- (ii) financiers to adapt their instruments to the particular problem addressed;
- (iii) stakeholders to concert their efforts and jointly structure the project in technical, institutional and financial terms;
- (iv) use of funding to be done in a transparent and accountable way and monitored by those who ultimately pay for the investments: users and taxpayers.

Stakeholders involved in financial planning and project structuring. Since the most important part of the reimbursement will have to come from users and taxpayers, it is necessary that they have a say in the process of preparation, structuring and development of the project and its financing mechanisms with all other stakeholders. Only in this way a better matching of the demand and supply of financing and the development of feasible financing mechanisms can be achieved.

Partnerships concerting such efforts will increase the repayment capacity, enhance the creditworthiness of local governments and local authorities and consequently reduce the cost of financing. This of course needs to be accompanied with more transparent and accountable management processes, for example by making the users shareholders. The local financing capacity will consequently increase as untapped resources may develop. Also the willingness of users to pay will increase, as financing through local public and private resources will implicitly contain corrective mechanisms ensuring service delivery and payment for services. This is often lacking in fully central government funded actions.

Though *Official Development Assistance* (ODA) is only a small part of the total amount of money required to invest and manage water services, its role can however be highly significant in developing confidence and creating access to local capital markets. Provision of (partial) guarantees can enhance creditworthiness and develop confidence in local currency markets. Grants can be effectively used for project development and structuring and the development of associated need for capacity.

The initiatives taken on coordination of aid by bilateral and multilateral financing agencies are strongly encouraged to enable further development of local capital markets making *local currency loans* possible and more attractive.

To enable effective local financing, central governments have to *empower, facilitate and strengthen the capacity of local stakeholders* in development, structuring, implementing and managing local projects. This requires effective decentralisation and the devolution of not only responsibilities but also of the associated budgets. The pace of this implementation needs to be carefully phased, as competencies and capacities differ from place to place. Careful management of the relationship between local and national government is needed.

The emerging *local private sector* can also contribute in the structuring of finance, especially as these companies may contribute to ensure reliable delivery of services and their associated costs and prices

A notable initiative is the development of *decentralised funds* based on local, national and international solidarity and not forming part of the public budgeting systems. Twinning arrangements of cities, towns, utilities and operators gain more and more ground. Though still relatively small, these arrangements create awareness, and can stimulate actions at a local scale..

In financing arrangements special attention has to be given to the poor, especially to the *poor people in poor cities and towns*. Sustainability of services depends on the financial health of the service provider. In poor areas as elsewhere, the cost of service provision needs to be in balance with the potential of revenues (user fees and tax payer contributions). Technology selection and service levels need to be adjusted to this potential. Pro-poor tariff structures are necessary. Incentives need to be given to provide the poor with access to safe water and sanitation. *Output Based Aid* is a promising instrument that can provide these incentives. Solidarity among customers, cities, and countries can greatly assist the aim of providing the poorest with access to basic services. *Debt swaps* for water supply and sanitation or for project structuring and preparation are also suggestions made.

The Year of *Microfinance* 2005 has generated interest in promoting this form of funding, in particular how to draw the large commercial banks into wholesaling money to specialised microfinance institutions, and the best use of outside support to make the latter self-sustaining. The potential of microfinance for water is only just developing and still much is to be learnt. However, in several places it has been introduced successfully.

Financing Water for Agriculture

Financing water for agriculture is complex. The use of water in agriculture, and rural occupations more generally, takes many forms, and there are many sources and options for finance. Diversity and choice of finance are highly desirable, and should be encouraged.

- Planning for *multiple water use* recognises the reality that water is needed for productive use in rural households, which supports the ability to pay for water.
- Water for agriculture is being called upon to play new *social and environmental demands*. Farmers will come under growing pressure to make better use of increasingly scarce water supplies.
- Farming takes place in a highly *distorted economic environment*, the result of both national and international factors. Water policies and institutions urgently need reforming, but this should recognise the many-often conflicting- purposes that agriculture serves in the community.

The next generation of investment in water for agriculture is likely to be very different from the last one, with less investment in large surface irrigation schemes, and relatively more in private groundwater, modernisation of existing schemes, improved efficiency in water use, drainage, etc.

The prospects for funding this sector are closely bound up with reforming its governance and institutions to enable it to generate more of its own funds and become creditworthy for external finance. More selective and purposeful use should be made of funds available.

- External aid should be used more for facilitation, leverage and capacity support than in direct credit operations.
- Public investment and recurring subsidies will continue to be appropriate where water provides a public service that could not be supplied by other parties, or where it has sizeable external benefits.

Water development in agriculture entails specific risks. Products and procedures need to be designed to tackle these risks head-on, in order to draw more funds from existing sources into this sector.

The complexity of the financing for water in agriculture calls for a better insight in mechanisms, interactions between local, national and international markets, governance and production structures and in the end, who is paying for what?

Introduction

The report of the World Panel on Financing Water Infrastructure presented at the Third World Water Forum in Kyoto set an agenda for action by the world community. Progress will be reported to the Fourth Forum in Mexico in 2006. GWP, WWC and their many partners have been monitoring follow-up and are organising a series of actions including:

- Beacon
- Sequel Panel
- Working groups:
 - o Financing Water for Agriculture
 - o Access to Financing for Local Governments
- Website Financing Water for All

Members of GWP and WWC, regional coordinators, and other interested parties are urged to maintain the impetus of this process by contributing case studies and other evidence of financial reforms and innovation for use by the Panel and working groups. Material will also be posted to the new Website.

Aim

The aim of the beacon is to present at the 4th World Water Forum to politicians, local and national governments, users, civil society, service managers, financing institutions and donors:

- a spectrum of viable and affordable financing options and mechanisms for strengthening local action
- a set of proposals to enable effective application of such models

and to obtain their commitment to enable their appropriate and effective introduction and use

Expectations

Through the regional and local activities organised under the themes and cross cutting perspectives the beacon expects to learn on

- Innovative financing mechanisms used for financing and strengthening local initiatives
- Local Action Cases on innovative financing - key success factors, main constraints and ways these have been solved
- The development of volume of local finance, ODA, lending and investments in the water sector.
- Addressing the questions:
 - o Why is demand for financing low while the needs are so high? To what extent and for whom is investment in water is a (political) priority?
 - o How is the demand process linked to the supply? What are the local processes and what can be recommended to remove obstacles?

Background

In March 2003, the World Panel on Financing Water Infrastructure (the "Camdessus Panel") produced a report, "Financing Water for All" (FWA), which made a large number of recommendations aimed at increasing the amount of finance going into the international water sector. The World Panel disbanded on the completion of its work.

The scenario adopted by the Panel was the projection made in the WWC World Water Vision and the GWP's Framework for Action of the need to double annual investment to ensure global water security by 2025. This included all the major water-using sectors, such as households and municipalities, farms, industry & commerce, wastewater treatment, environmental uses, flood control and various other functions of water management.

Since the launch of the report its agenda has been taken up by many of the involved organisations to follow up the report recommendations. In particular, the G8 Heads of State in Evian, France, highlighted several of the recommendations and requested the World Bank to co-ordinate action with the regional development banks. The GWP, WWC, donors and other partners have held a number of "Follow up Group" meetings to promote and monitor action on the recommendations. This group, together with the World Bank, decided that further work was needed to look in more detail at the special issues concerning two areas in particular: firstly, financing water for agriculture; and secondly, the access to finance of local governments.

GWP, WWC and the Secretariat of the 4WWF have taken steps to form working groups to consider, consult, and report on these issues at the 4WWF in Mexico in 2006. Sr Angel Gurria, a previous Finance Minister of Mexico, has agreed to chair a Sequel Panel of high-level personalities who would oversee the Working Groups and report on implementation of Financing Water for All at the Forum. As part of its role, the Sequel Panel will act as Beacon for the FWA, presenting evidence on local experience and initiatives on the kind of innovative financing mechanisms and other reforms advocated by the Camdessus Report. It is intended to include case studies and other evidence in the new section of the WWC/GWP Website on Financing Water for All.

This Briefing Note provides guidance on the kind of evidence being sought. It is in six parts:

- i) summary of key points in the Camdessus Report;
- ii) recent trends;
- iii) guiding principles
- iv) funding IWRM
- v) financing water for agriculture;
- vi) sub-sovereign and municipal financing

Camdessus Report: key points

In its report "Financing Water for All", the World Panel on Financing Water Infrastructure made the following points, among many others:

- All existing sources of finance for investment must expand: domestic governments (by far the largest source at present), official development assistance (oda), lending from Multilateral Financing Institutions (MFIs), commercial loans, private equity, voluntary contributions, etc.
- The water sector urgently needs reform to make it a more credible channel for more funding, and to generate more funds itself. Improved cost recovery is essential, but public subsidy will continue to be needed, though on a more predictable and transparent basis. Half the report is dedicated to "governance" measures of various kinds.
- The water sector takes highly diverse forms in (and even within) different countries and there is no universally valid blueprint for reform. The choice of organisational model for the water sector should be made on pragmatic grounds, recognising local realities.
- There should be much more direct funding at sub-sovereign and local levels, where the real responsibility for water provision lies. Currently, most funding goes in at central government level.
- Water revenues arise in local currency, hence raising loans or equity abroad carries an inherent foreign exchange risk. The report dwells on ways of developing *local*

capital markets and savings sources, and proposes a “devaluation liquidity backstopping facility” to alleviate the pain of major devaluations.

- More ODA is necessary, but should be targeted, particularly to the achievement of the Millennium Development Goals (MDGs), and should be applied as a catalyst to lever in other flows. Aid should not crowd out other sources, nor smother local or private initiatives. There should be greater use of guarantees.
- Major parties should be held to account for their commitments and performance. Domestic governments should produce action plans and programmes for achieving MDGs. Donors and MFIs should report on their performance in relation to commitments. A “control tower” and group of “wise persons” should provide international monitoring.

Recent Trends:

The record on water financing in the last few years has been mixed, with some advances, and some reverses:

- international commercial bank lending and project finance is at a low ebb
- financial engineering, structured finance, guarantees, etc are attracting more interest.: MFIs are refurbishing their products and practices, particularly in respect of guarantees; some bilateral agencies have introduced guarantee programmes.
- national host governments have been slow to engage: there are many other priorities, and water is unappealing to many finance ministers.
- conventional oda and lending from bilateral and multilateral agencies continue to dwindle – due to weak demand and a thin project pipeline
- as part of “reversing the financial architecture”, there is great interest in sub-sovereign lending , especially for municipalities
- there is a strong desire to get funds to local initiatives, but a shortage of feasible schemes. There is growing interest in “partnering”. The EU Water Facility has a dedicated component for “decentralised” funding.
- international private equity is a shrinking and expensive source because of high risks. Companies remain interested in low-risk operations.
- Little progress has been made in creating schemes for mitigating devaluation risk, but local currency borrowing as a way of tapping local savings is being promoted by the growing interest in local currency guarantees.

Guiding Principles:

Over recent years the GWP and WWC have helped to build a broad international consensus on the approach to water financing. The Camdessus Report took the process further. As a result, there would now be substantial agreement on the following principles:

1. In each country, the “water sector” should be dealt with as an **integral whole**, financially as well as in other respects. This is consistent with the philosophy of Integrated Water Resource Management, in which different parts of the water sector are viewed in relation to each other, with awareness of the links between them. Different parts of the water sector are affected by the financial health of other, related, parts.
2. However, the different parts of the water sector are likely to need their own distinctive financing solutions. **Variety and innovation** are quite consistent with the integration principle.
3. There should be appropriate **decentralisation** of responsibility for raising finance, but within a clear national policy framework (including conditions for central grants, guarantees, etc.). Sub-sovereign bodies (e.g. municipalities, irrigation boards, regional development corporations, water user associations etc) should have access

to external finance where they are capable of servicing the debt and where the national macroeconomic situation is conducive.

4. Financing options should be **sustainable**, which ultimately means **affordable** to the users or within the long-term fiscal capability of public authorities. Subsidies may be part of the long term solution, but ideally should be targeted to those in greatest need or in return for specific public benefits, and should either be fiscally sustainable, or tapered out over time.
5. Certain sub-sectors or water management functions with a clear public benefit (including public goods¹ and services with external benefits²) are appropriate areas for continuing **public investment and subsidy**.

Funding Integrated Water Resource Management

The water sector is large and diverse, and adequate funding is essential for all parts of it. This means that we must consider the needs of all its components, including:

- Water resource development & management
- Environmental management & conservation
- Research, administration & policy development
- River management, navigation & flood control
- Hydropower
- Agricultural irrigation
- Industrial, commercial & touristic water use
- Municipal & household water use & sanitation
- Wastewater collection & treatment, and sludge disposal

In conformity with the principles set out in section (iii) above, some of these functions confer public benefit or positive externalities and deserving candidates for public financial support (e.g. research, environmental management, river management, flood control, etc.) Certain sectors can be expected to seek their own financing solutions (industry, commerce, tourism). The larger urban centres ought to have sufficient financial critical mass to be largely self-supporting.

Rural services, smaller urban centres, and the poorer peripheries of cities may need cross-subsidy from more lucrative services. Wastewater collection and treatment is normally paid for from freshwater sales, though initially willingness-to-pay is lower than for freshwater and some subsidy may be required. Irrigation is very diverse, and generalisation is more difficult (see section v below).

Multipurpose water management bodies have a variety of potential sources of income, illustrated in Box 1.

Box 1. Laguna de Bay Development Authority, Philippines

Laguna de Bay, close to Manila, is a large freshwater lake, one of the largest in South-East Asia. It is a traditional fishing ground for the local population and a source of water for agricultural, commercial and domestic use. It contributes to hydropower generation through a pumped storage power plant supplying the Luzon power grid. The growth of industry in the watershed, which now supplies one-third of national manufacturing output, has caused serious pollution of the lake, which threatens the fishing industry and

¹ Something of clear public benefit that effectively has to be provided by governments because private individuals or firms would not be able to recover sufficient revenue from it. In the present context, flood control and environmental conservation are examples.

² A benefit which does not wholly or partly accrue to the party undertaking the action, but which affects others. This can also apply to a cost which affects third parties, which in such a case can be corrected by a tax or levy on the instigator.

other users.

The Laguna Lake Development Authority was formed in 1996 to promote balanced use of the Lake's waters. The Authority has the authority for environmental protection and regeneration, and powers to promote the sustainable development and use of the waters, fisheries and wetlands. It is an independent body through a special charter, receiving no funds from the national budget and self-supporting through its regulatory and environmental fees.

Its revenue sources are as follows:

- Processing fees for the review and approval of plans
- Fees for the beneficial use of lake water for fisheries, recreation, municipal, industrial, agricultural, navigation & waste disposal purposes
- Fees to compensate for damage done to the lake from water pollution. (LLDA operates an environmental user fee system, set at a level that is an incentive to firms to treat their wastewater instead of releasing it untreated).
- Fishpen, fishcage and related fees (This is one of the largest revenue sources. Licences are issued to the highest bidders for specific areas)
- Fines and penalties for violation of the Authority's rules
- Processing fees for clearances and permits
- Discharge fees and fees for permission to transport oil and other petroleum products across the Lake
- Ferry clearance and permit fees
- Fees for laboratory services
- Receipts from the production and sale of fish etc. from LLDA projects
- Shoreland management and lease fees

In the near future, the LLDA has plans to create a trust fund with its revenues that can be used to finance environmental and water-related projects. There are also proposals to charge fees to all users for water abstraction, and to create a subsidiary company to implement developments-which would have more commercial and financial freedom.

Source: Asian Development Bank. Paper produced for Camdessus Panel, April 2002.

Examples of funding sources for IWRM

- *Licence fees*
- *Concession & royalty fees for use of public assets*
- *Pollution charges*
- *Fines and penalties*
- *Sales revenues*
- *Lease fees*
- *Subsidies from downstream users*
- *Transboundary water management funding options*
- *Etc.*

Financing Water for Agriculture

Although this working group is focussing on agriculture, the broader task of raising rural incomes, eliminating pockets of hunger, and meeting the food needs of growing poor cities will involve all aspects of rural development, including the production of non-food items and crops for export. The topic extends beyond agriculture in its narrow sense, taking in other water-intensive natural resource activities such as livestock production, artisanal fisheries, etc. Preparing and processing foodstuffs can also be water-intensive, whether done on-farm or on a commercial scale.

Water pollution from irrigation (saline and chemical-contaminated run-off), livestock (non-point pollution from slurry) and processing of food and industrial crops is a major problem and there are heavy costs involved in treating these effluents. The provision of drainage from irrigation schemes is another major outlay, often neglected, where there is a large backlog of investment and maintenance in order to maintain the productivity of existing command areas.

Following the WWC/GWP Framework and Vision estimates, it is commonly thought that the annual investment requirements for agricultural water will need to rise from the current levels of (USD bn.) 25-30 to 40 by 2025. The original estimates were based on some very rough calculations, which have not yet been seriously refined. There has been a dramatic decline in investment in new irrigation schemes, and most future investment is likely to be in the modernisation and rehabilitation of existing assets. Investment in new hydraulic infrastructure, such as dams, will also be more selective than previously.

Some observers contest the above estimates, believing that great gains in productivity could be obtained from existing infrastructure, without major new investment, with improvements in farm practices, responding to better incentives.

Cash flow from water sales revenues, supplemented by short term bank loans, should not be overlooked as a source of finance for new investment, especially smaller schemes. Cash flow also matters for the upkeep of systems: if insufficient money is devoted to routine maintenance of water sources and structures, this will increase eventual investment for major repairs and rehabilitation if the productive potential of land is to be sustained. Cost recovery through water pricing is the most sustainable basis for such recurrent funding, but it is only realistic to recognise its limits in this difficult sector.

Current sources of finance

The different types of irrigation schemes have their own distinct sources of funds. The financial sources of the private irrigation sector are difficult to gauge with any accuracy, hence overall estimates are biased towards the large public irrigation schemes, which rely overwhelmingly on public national and international sources. Within the latter, lending and aid from international sources is fully documented, whereas the various kinds of support and subsidy from national governments is impossible to collate on the same basis. Hence estimates of the current amount of investment and its main sources are very crude.

The funding of large public schemes is relatively well understood, since it relies almost entirely on national government loans and subsidy (including guarantees for external borrowings) plus support from international agencies for some of the more prominent projects. From the latter, lending by the World Bank and other multi-laterals for irrigation declined from a peak in the mid-1980s of ca. USD 3 bn. to ca. USD 2 bn by the late 1990s. This was partly a reflection of the worldwide decline in investment in new irrigation schemes, and also responded to growing opposition towards the construction of new hydraulic infrastructure of all kinds. National government loans and subsidies for this purpose have also been trending downwards. Some countries, e.g. India, have issued state and municipal bonds for financing irrigation, with government guarantees.

While it is difficult to generalise about the private sector, commercial farmers tend to use a combination of loans from banks and other specialised credit institutions, where these are available, supplemented by their own savings and equity. Small-scale farmers are more likely to use informal credit sources and micro-finance to supplement their own inputs in cash and kind.

Diversity of the sector

The nature and scale of the financing problem varies greatly between different parts of this sub-sector, and the specific circumstances of each, e.g.:

- large public command areas producing low-value staple crops using surface irrigation;
- groundwater irrigation from tubewells, privately financed;
- farmer-financed schemes, based on run-of-the-river, mini dams etc.;

- large commercial farms and plantations.

Forming a view on the size of the financing need in this sector, and the types of finance needed, will depend on the view taken about what kind of water use we expect to evolve (e.g. the relative importance of the above categories).

Distinctions should also be made between the financing needs and prospects of farms with different characteristics and situations. Financing options depend on such factors as the following: livestock or arable; subsistence, or commercial; local sales or export; high- or low-value crops; stand-alone farming, or part of a multi-purpose scheme; degree of water scarcity and /or conflict with other uses; whether involving major hydraulic structures, or lesser (including on-farm) investments; cost and sophistication of agronomic & irrigation technology and inputs used; use of water for basic or supplementary/insurance purposes; feasibility of measuring on-farm water consumption , etc.

Examples of financing sources for agriculture:

Agriculture and irrigation have a number of different “layers”, each with distinct financing needs and potential funding sources:

- i) *smallholder farmers, with relatively small credit needs*
 - *informal savings groups,*
 - *cooperative savings and credit arrangements,*
 - *schemes operated by NGOs and other voluntary organisations,*
 - *moneylenders and traders,*
 - *project-specific credit,*
 - *micro-finance through local formal intermediaries, etc.*
- ii) *commercial-scale and “emerging” farmers need larger amounts of finance from:*
 - *local commercial banks,*
 - *other financial institutions in the formal sector (e.g. specialised agricultural credit agencies),*
 - *suppliers’ credit, etc..*
 - *Profitable ventures with sound markets may be able to tap into more innovative forms of private finance.*
- iii) *large-scale public infrastructure is likely to continue to need public support, from:*
 - *central government subsidies, loans and guarantees,*
 - *foreign grants and concessional loans,*
 - *municipal bond issues, etc.*
 - *private concessions are being trialled in a few cases*

New schemes of this kind are likely to be relatively few and carefully chosen, after careful assessment of their various impacts. Existing systems will need adaptation and modernisation.

Access to financing by local governments & other sub-sovereign bodies

Many countries have witnessed a trend towards the decentralisation of responsibilities for providing services towards regional and local bodies. This has often included the transfer of powers over tariff setting and funding. Proposals in the Camdessus Report would facilitate this trend. It was argued that funds should increasingly be directed at sub-sovereign entities – regional bodies, municipalities, utilities, etc. – on the grounds that services are provided at this level, and accordingly they should be empowered to raise more of their own funds. Many

proposals in the Camdessus Report address constraints on lenders, improving the creditworthiness of sub-sovereigns, clarifying centre-local fiscal relationships, etc.

Directing finance at entities concerned with service provision has several benefits:

- it improves accountability- it is clearer how much is needed, where the funds go, how much they cost and what needs to be done to balance the costs with revenue measures.
- It improves predictability, since operating agencies have greater certainty about their future finances and are less dependent on arbitrary decisions of central government.
- Financial delegation also gives local authorities a stake in the project concerned and reinforces their commitment to cost recovery.

There are some offsetting negative factors in financial decentralisation. Local indebtedness can get out of control, through incompetence, political opportunism and irresponsibility. This then gives central governments a dilemma - whether to bail out insolvent local authorities or to let them face the consequences of their actions, with the resulting hardships to local residents and electors. Loans contracted in foreign currency are particularly risky for projects whose revenues are in local currency, which includes most infrastructure. Central governments have greater means, and more diverse revenue sources, to offset risks of this kind.

Central governments can normally raise funds on more advantageous terms than local bodies (though in some cases cities have a credit standing equal to sovereign. The expertise and experience available to central governments can stand them in good stead when dealing with international bankers and prospective private investors, while local bodies might strike poorer deals. The reverse side of the coin is that local negotiators tend to be more familiar with the projects to be financed, and hence have greater credibility and commitment in arriving at a deal.

There have been some interesting and encouraging developments. Agencies that have traditionally lent against central government guarantee (sovereign risk) are starting to develop experience taking direct sub-sovereign risk. EBRD, which has the longest experience of sub-sovereign lending, has a number of examples in Eastern Europe of “graduating” from sovereign to sub-sovereign lending, and then to the third level, that of corporate or project risk-where the loan is secured by the creditworthiness of the utility or company, or the expected cash flow of the project itself. In this process the “guarantee capacity” of the central or municipal government is released for use on essential services that do not have revenue generating potential. Lenders can obtain the political comfort they need by means of Municipal Support Agreements, under which the local government undertakes to ensure that the borrowing entity lives up to its commitments on tariffs etc.

A number of countries are encouraging the involvement of credit rating agencies with sub-sovereign bodies. The agencies give an objective and reputable assessment of the credit standing of municipalities, utilities, environmental funds, etc. which, if positive, can enable them to raise funds on better terms. This encourages the growth of a local capital market by giving lenders more reliable information, and creates benchmarks and standards of good practice. Credit rating is spreading in a number of countries.

Some municipalities have successfully raised their own bonds for infrastructure finance. Sometimes this is with the assistance of central government guarantees, though not all governments encourage local bond issues. Multilateral financing Institutions (MFIs) such as the World Bank, IFC and the regional development banks can help local bond issues by providing lenders with Partial Credit Guarantees or using the A and B Loan system, in which holders of B loans have the same security as the A loans made directly by the MFIs themselves. USAID’s Development Credit Agency has also backed local bond issues for water in several Indian states, using the model of revolving funds, with an initial injection of grant funding, and sustained by risk sharing with local financial institutions.

Commercial bank lending is another potentially important source of funds. At present, banks are often unfamiliar with the market for long-term infrastructure finance, and prefer lending on short terms.

Even with a will from all parties to devolve financing to local levels, it will not happen if local bodies are, or are perceived to be, weak, unreformed and inefficient. The relevant local bodies need to be “corporatised” to give them enough autonomy, transparency, and accountability in their relations with higher levels of government and with their own consumers. They also need a more commercial outlook, and this implies much more cost recovery from users than is now customary. Raising cash flow can be achieved by reducing waste, improving operating efficiency, revising and if necessary raising tariffs and making them inflation-proof, and improving bill collection. A number of countries use the process of peer-group comparison as a spur to improved performance.

These measures will enable service providers to produce more of their own cash needs, and improve the terms on which they raise external finance. One of the hardest parts of institutional reform is to persuade public utilities and local governments to view their local populations as customers, with all that implies. One of the less obvious benefits of charging people the real cost of services is that they become much more active in influencing the quality of service they get, which benefits both sides of the bargain.

A large minority of households in many cities of developing countries regularly buy water from small-scale water providers (SSWPs) rather than from their public service monopoly. One survey³ of a number of Asian countries found that SSWPs generally operated illegally (because the public utility had a service monopoly) and received no official financial support, nor access to commercial loans. Hence most SSWPs fund their operations from private loans at very high rates, which are reflected in prices charged. Where the legal environment is more favourable, the prices charged tend to be much lower, and in some cases are close to those of the public utility. For instance, In Ho Chi Minh City some private operators that draw water from the public mains for resale have signed contracts with the utility defining the tariff they charge.

Examples of measures to encourage decentralised financing:

- *Use of international & national government guarantees for sub-sovereign bond issues and other borrowings*
- *Encouraging the spread of credit rating amongst sub-sovereign entities*
- *Improved clarity in fiscal relations between central and local governments, and use of fiscal intercepts as backing for local revenue raising.*
- *Enhancement of the financial status of local water companies through tariff reform, improved billing methods and collection rates, and better attention to customers' needs.*
- *Capacity building of water undertakings through institutional reforms, staff development, public-public and private-public partnerships, national and international peer-group comparisons (e.g. using benchmarking), greater transparency and exposure to civil society, etc.*
- *Improvement of enabling environment for local private operators)*
- *Creation of options for private participation in operation, leasing, or joint ventures.*

³ Reported in Arthur C. McIntosh, “Asian water supplies: reaching the Urban Poor”. Asian Development Bank, 2003.