Draft

Report on the expert group meeting on "Financing basic utilities for all" (New York, 26-27 June 2006)

(I) Setting the agenda: the goal of the 2006-2007 multi- (I)

of planning and finance took a lead in sector reform and coordinate effectively with water and energy ministries. Contextually, development partners must recognize local ownership of reform and support capacity building. At the local level, national resources could be used to leverage local financing. This would allow for additional financing, increased market rigour, and the development of the national financial sector. For instance, new business lines in water projects would come into existence for micro-finance and domestic finance institutions.

An illustrative example for the use of microfinance for water projects came from Kenya, where micro-finance institution were financing community-managed piped water projects in rural and peri-urban areas. This represented an innovation as in this case microfinance lending was directed to community projects instead of households. In order to scale up microfinance lending for small water or electricity projects, it was necessary to ensure a regulatory framework that gave legitimacy to small providers and mitigated risks. In addition, government resources should not crowd out local private investment, but rather encourage it. Government resources could be used in various effective ways, for instance, for the development of credit assessment tools, or for lowering high initial transaction costs for micro-finance institutions. Another important task was to address supply-side constraints and help local communities develop bankable opportunities.

Discussion

Financing options at the national and international level

Discussants concurred that sector financing was indeed extremely fragmented in most developing countries. This was due to the prevalence of the project financing approach and a lack of coordination among a wide array of donors. More coordination was needed at the national level to introduce and guarantee the success of programmatic sector approaches. Other critical issues raised included the need to differentiate financing needs of low and middle income country and the importance of sound regulatory frameworks. Participants also agreed on the need to enhance internal government revenue generation through increased economic growth and a more efficient tax collection system. Indeed, experience had shown that there was significant room in developing countries to increase the tax revenue/GDP ratio by some percentage points. However, there was also wide agreement that increased development aid was needed to fund utilities and to support long term endeavors to reform domestic revenue collection, i.e. to improve tax administration and tax policies. In this regard, many speakers called for further untying of aid and more focus on budget support. Some speakers urged to put more emphasis of future research on the potential of philanthropy in financing utilities.

Debt instruments at the national and international level

Participants pointed to the limits of the recent G8 debt relief initiative for the poorest countries in terms of domestic resource generation. An ongoing UNDP study on Zambia showed that the G8 Gleneagles debt deal freed up very few new resources as stricter fiscal targets were imposed and Official Development Assistance (ODA) flows decline. One speaker highlighted the need for ensuring the feasibility of loan agreements. The participant mentioned the example of the city of a developing country which went bankrupt after it failed to serve interest rate payments for a substantially increased loan from the World Bank.

Financing options at the municipal level

Many speakers stressed that increased fiscal decentralization often implied too many conditionalities and spending constraints for municipal and local providers. Others stressed, that good credit rating would be critical for municipalities' access to finance. In this regard, participants elaborated on the experience of Johannesburg, which went from bankruptcy in 1999 to an A+ credit rating seven years later The credit rating was achieved through improved information flows and supervision, better data collection, and enlisting the help of the Auditor-General. The integration of multiple stakeholders in the planning process was also critical. The potential of public-public partnerships, a concept known as twinning, was also highlighted.

Financing options at the local level

During the discussion participants highlighted the role of community finance in Kenya, which made up for 40-50 % of all funding for water and sanitation. Improved data collection was needed to better understand the potential of communities in funding utilities. To increase the capacity of community providers, research should focus on designing support services for community projects. Microfinance institutions could also play a critical role in supporting independent but legislatively backed community management systems. This was why governments should provide space for Micro Finance Institutions (MFIs) as well as increase focus on leveraging additional resources, especially at the local level. On the other hand, the potential of MFIs was limited as, at present, they did not provide long-term financing.

Increasing absorptive capacity at all levels

According to some speakers the international debate on financing basic utilities was characterized by an exaggerated focus on quick fixes and fast delivery mechanisms to help achieve the MDGs. This had the potential to divert emphasis away from capacity building. Increased absorptive capacity was particularly important in light of bigger donor flows. Moreover, capacity building needed to focus on identifying and supporting capacity "providers" on the ground. There was also a great need to improve data collection. As mentioned in the World Bank's report on "Capacity building in Africa" tracking capacity building efforts was extremely difficult. It was also stressed that capacity building should not only be donor driven but should be enhanced through South-South cooperation.

(III) Paying of the debt: ensuring sustainability through internal revenue Generation

Presentation by Mr. Girish Sant, Founder, Prayas Energy Group, India

The speaker highlighted that in the 1990s, arguments of economic efficiency had been used to reduce subsidies. As a consequence, tariffs had been increased and the poor had been negatively affected. Yet, cost recovery had not been achieved. Because of equity considerations, and due to the inability to achieve cost-recovery for water and electricity through tariffs, it was now accepted that subsidies were needed. The main unresolved issue was how to limit subsidies, target them, and make them more efficient. In many instances, such as water supply for agriculture in India, subsidies created perverse incentives leading to an inefficient use of scarce public resources. In India, inefficient operation of utilities for agricultural water provision had led to misallocation of about USD 2-3 billion per year. Also, since the need for government financing of subsidies was very high, it was important to find ways to increase government revenues, as well as to allocate more of these resources to the water and electricity sectors.

One constraint for the affordability of utility services was the setting up of inappropriate schemes, either through the non-use of low cost options or through the use of schemes that did not serve the priority need of the majority of the population. For instance, under pressure for quick results, the rural electrification policy in India had ignored system optimization by ignoring the promotion of efficient lamps. System optimization could reduce both supply and consumption costs, thus reducing the gap between 'cost' and 'willingness-ability to pay'.

Another example was the "Urban development and Costal Environment Management Project" of the Asian Development Bank in Karwar, India. There, a USD 24 million project was implemented to provide piped water for a community of 20,000 families. Yet, 20% of the community already had access to water. Moreover, the critical problems of sanitation and sewage leading to pollution of the water itself were not addressed. In addition, an alternative low cost option of using water from the nearby river was not explored based on an unconfirmed perception that a close-by nuclear power plant could contaminate the river. As a result, the set-up scheme was incomplete, inefficient, and it represented a heavy financial burden. Inefficiency in delivery, as well as in utilization, could thus lead to unaffordability.

provision of utilities. This could be done by giving more voice to the under-privileged and poorer segments of the population.

Discussion

Minimizing and Recovering costs

Speakers stressed that full cost recovery was simply not possible for water and electricity in impoverished countries. One of the factors that make cost

In addition to severe structural challenges, such as high poverty rates, social inequalities, lack of supporting infrastructure, and the need for land reform, the speakers highlighted the fact that Brazilian municipalities faced severe financial challenges when it came to providing access to water and sanitations. These challenges included restrictions on new public debt, exceptionally high financing requirements due to high interest rates and high levels of tax burdens. To provide adequate resources of financing to municipalities, Brazil had instated a public fund for compulsory saving (FGTS), based on a contribution equivalent to 8% of the employer's payroll. The FGTS served two purposes. Firstly, it was an unemployment insurance fund for dismissed workers and secondly, it was used to fund Federal urban development projects (water, sanitation and popular housing) at low interest rates.

However, fiscal measures of the Brazilian Ministry of Finance and the IMF aimed at containing inflation paired with the need to meet high public financing requirements had restricted lending to the public sector. One of the policy implications was that the National Monetary Council prevented FGTS to contract new investments in the water and sanitation sector from 1998 to 2003. Accordingly, as of January 2006 only R$74.6 billion of FGTS funds were allocated to their intended purpose in housing and water supply and sanitation projects while R$53.08 billion were allocated in public bonds. In the end of 2003, after long negotiations between Ministry of the Cities and Ministry of Finance, a decision from the National Monetary Council allowed banks to lend R$3,7 billion from the FGTS and other funds to public borrowers enabling them to invest “exclusively” in water supply, sanitation and solid waste management projects. In 2005, a new authorization to invest took place, adding some R$2, 2 billion to be borrowed by public entities and applied in water supply, sanitation, solid waste management and urban drainage projects.

According to the speakers, the achievements of 2003 and 2005 were very important to pave the way for a new era after the ending of the IMF loan agreement with Brazil. However, it was critical to overcome the lack of stability of the current situation, which was characterized by a “stop-and-go” policy of funding municipal financing of utilities. In this regard, it was important to approve and implement sound guidelines for the planning, regulation and monitoring of utilities. These guidelines should aim at a greater efficiency of operators and increase public control and monitoring.

Finally, the current administration should apply government measures to increase public revenues through spurring economic growth. At the same time, it should give municipalities additional financing space through lower fiscal constraints and reduced tax burdens.

Discussion

Public and private sector risk

Some speakers stressed that public sector risks should feature more prominently in discussions on financing utilities for all. This should include “sovereignty risk”, i.e., the risk of losing policy space when signing bilateral agreements or multilateral agreements with the Bretton Woods institutions or the

WTO. This was particularly relevant in the area of imposed liberalization of capital accounts and domestic financial markets. Some participants also stressed that there were risks developing countries faced in joining the WTO regarding the usage of cross-subsidies and other hidden conditionalities. Private sector risk would to a large extend also be relevant for public sector investments. Research should focus on mitigating exchange rate, interest rate, inflation and regulatory risk without imposing additional burdens on overstretched national budgets or the poor.

The role of monetary and fiscal policy

Many speakers stressed the importance of monetary and fiscal policy in promoting domestic financial markets that could help generate long term interest bearing financing instruments. Several participants questioned excessive inflation targeting by the central bank as this would often reduce the supply of adequate financing instruments due to high real interest rates and very tight monetary and fiscal policies.

(V.) Regional Meetings

The participants of the meeting stressed the importance of a multi-stakeholder initiative on "Financing basic utilities for all" and emphasized the political relevance of regional meetings. In order to ensure a regional balance and to take into account the different needs and challenges to middle- and low-income countries it was suggested to organize a total of three regional consultations in Latin America, Africa and Asia.

The representative of the Brazilian Ministry of the Cities offered the Friedrich Ebert Foundation and the Financing for Development Offic(balanc-875 srD -0.1688 Tc -0.02nts ou38

Attachment 1

Revised tentative working agenda for multi-stakeholder consultations on "Financing access to basic utilities for all" organized by the Friedrich Ebert Foundation in cooperation with the Financing for Development Office

1. **The 2006-2007 multi-stakeholder consultations on financing basic utilities for all**
    - Financing access to basic utilities for all- where do we stand?
    - Goal, value-added and modalities of consultations
    - Discussion of the revised background document

2. **Mobilizing finance: Stable and predictable financing mechanisms for utility providers at all levels**
    - Financing options at the national and international level
        - Multilateral and bilateral development aid
        - Debt instruments at the national and international level
    - Financing options at the municipal level
        - Municipal banks, municipal bonds and pooled financing arrangements
        - Fiscal transfers and the role of conditionalities
    - Financing options at the local level
        - Microfinance institutions
        - Utility credit schemes and other mechanisms
        - Leveraging local resources
    - Increasing absorptive capacity at all levels
        - Capacity building, including through South-South cooperation

3. **Paying of the debt: ensuring sustainability through internal revenue generation**
    - Minimizing costs
        - Identifying priority needs of the poor
        - Increasing efficiency
    - Recovering costs
        - Appropriate tariff structures
        - Consumption-, access-, and cross-subsidy mechanisms
    - Beyond cost recovery: allocating state revenue to utilities
        - Participatory budget planning
        - Fiscal Space
    - Increasing government revenue
        - Improving tax administration
        - Improving tax policies

4. Macroeconomic factors to be taken into account

- Public sector risk
  - Policy space
  - Financial market liberalization
  - Possible macroeconomic implications of aid inflows
- Other risk
  - Exchange rate, interest rate, inflation and regulatory risk
- The role of monetary and fiscal policy
  - Inflation targeting
  - Exchange rate and interest rate policy