What the World Needs Now… is Local Infrastructure Investments

Challenges and Solutions with a Focus on Finance

Lars M Andersson

Mårten Andersson Productions

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Challenges of today and tomorrow

Government on all levels around the world are striving to support growth in the aftermath of the recent financial crises. Some are doing well, others less so. In developed countries, as well as in emerging markets and developing countries, growth is required if we are to successfully deal with the challenges of our time.

And there are challenges! We are in the position to have very good knowledge of at least two major trends that will greatly affect the cities of today and tomorrow.

Urbanisation moves at a rapid pace all over the world. In 2007, for the first time in history, the urban population of the world outnumbered the rural. Two thirds of the world's population is projected to live in cities by 2050. According to the World Urbanization Prospects (UN 2014) "Africa and Asia are urbanizing faster than the other regions and are projected to become 56 and 64 per cent urban, respectively, by 2050".

This produces a set of difficult questions that need to be addressed:

- a rapidly increased need for public services and infrastructure investment in big cities. The infrastructure is essential in order for society to function. There is often an urgent need to upgrade systems for transportation of goods and people (commuters). New education facilities are needed, and so on. This produces a pressure to increase investment plans and the necessity to have access to financing.
- the necessity to provide local services in rural local authorities with less income (from taxes or fees). To be able to, for example, provide for the elderly who do not move to cities in the same extent as young people. Furthermore, they have the challenge of keeping the workforce for the production of the needed public services.

Another global challenge is climate change. The United Nations' Intergovernmental Panel on Climate Change (IPCC) presented a part of its fifth Assessment Report in September 2013. The research assessed by IPCC indicates that climate change is, with a probability of 95 percent, caused by mankind. If nothing is done, temperatures will rise and so will the sea level. According to the IPCC, the only chance to limit the rise in temperature to 2°C, is to radically reduce emissions.

Whatever the reasons are behind global warming, it will deeply involve every part of society. For local authorities, climate change will call for investments and adjustments of the production of public services.

Even though these challenges must be addressed at national level, their nature also points to an important role for local governments. It is the local politicians of the cities who will be at the forefront dealing with expanding cities and sustainable local development. This ordeal arrives at a time when local authorities in the developed countries are in a weak position due to cuts in state grants and rising social cost. In many emerging and developing countries institutional and financial relations with the national level remain unclear, although efforts to decentralise form part of a global trend.

Investment and growth

The communiqué from the meeting of the finance ministers and central bank governors of the G20 in February 2014 stated that higher infrastructure investment "is crucial for the global economy's transition to stronger growth". It is now a recognized fact that infrastructure investment is the most important mean to get the wheels of global economy moving again. In the World Economic Outlook (IMF October 2014), it is argued that there is a huge need for public investments and that now is the time to move to action.

In the report from IMF, the authors establish the fact that "public capital has declined significantly as a share of output over the past three decades in both advanced and developing countries". The conclusion is drawn that public infrastructure investments give such a boost to GDP that "the public-debt-to-GDP ratio does not rise. In other words, public infrastructure investments would pay for itself, if done correctly".

Within the OECD countries, local authorities are responsible for two thirds of all public investments. With the challenges that the world is facing, it is fair to say that local authorities will have to bear much of the burden of local infrastructure investments also in countries outside of the OECD. This means that possibilities for local authorities to work efficiently are key to overall growth. There are two aspects that are specifically important: the prioritisation of investment projects and the financing of them.

Financing of local infrastructure investment

Local government infrastructure investments can be financed with

- Taxes and/or fees and charges
- Transfers from central government
- Borrowing from banks or issuing debt in the capital market

It is a fact that local authorities' powers to impose taxes, rates, charges and/or fees are in many cases limited in both developed and developing countries. This is in spite of the frequently present rhetoric of decentralisation. Real decentralisation does not happen if the control of local finance is in the hand of the central government. A change is required if cities and other local authorities are to successfully meet future challenges. For developing countries, the problem extends beyond the lack of powers to introduce and maintain own-source revenues. The system for collecting local taxes and charges are in many countries inefficient and in need of improvement. When it comes to transfers from central government to local authorities, there is a call for long-term predictability and stability. Otherwise, long-term planning becomes extremely difficult. Also for these questions, reforms are necessary in a number of countries. To summarise:

the deciding fact concerning the possibilities to employ own revenues and/or transfers for the financing of local investment is the level of decentralisation in the respective countries.

The nature of local infrastructure investment makes it very difficult to use just one of the sources listed above. The use of debt is almost unavoidable as one of the means of financing. Debt is also an efficient tool to distribute the cost of an investment over the generations that will use it. This requires that cities must be given legal and other conditions to finance investments through borrowing.

But, of course, in order not to become over-indebted a part of the financing should come from own sources or from central government. Again, central government should clear the way for more efficient use of local taxation and employ long-term and stable systems for transfers to the local level. This is also a central consideration when using the debt instrument, which would presuppose a certain level of creditworthiness or, in other words, the ability to repay loans in a timely fashion.

The following is needed to efficiently use debt as a mean of financing:

- Legal capacity
- Institutional capacity
- Knowledge and skills
- A developed market for loans and/or bond issues

Even if this is fulfilled (which globally still is quite rare), there is one additional problem for cities and other local authorities. They are often relatively small and do not have sufficient funding needs to attract the attention of creditors. This is especially true for capital market transactions, where even big cities are struggling to have a frequent participation. And, without frequency in bond issuance the whole procedure becomes inefficient and expensive.

The good news is that cities and other local authorities are particularly suited for cooperation among themselves. Pooled financing has a number of advantages, which will be elaborated on below.

Pooled Financing Mechanism (PFM)

PFMs exist in many countries and have many different forms. In Europe, the Local Government Funding Agencies (LGFA) dominate. The oldest is the Danish agency, Kommunekredit, created in 1898 and the latest addition is the French agency, Agence France Locale, which saw the light of the day in October 2013. A LGFA is a special purpose agency owned by local authorities and, in some occasions, with minority shares held by central government. It issues bonds in the capital markets, domestically and internationally, and on-lends the proceeds to local authorities which are members/shareholders of the agency.

The US Municipal Bond Banks have a slightly different set-up. They are usually closely related to the various state administrations. The oldest Municipal Bond Banks are to be found in the states of New England, but the concept has also spread to other parts of the USA. In Canada, there are provincial entities for financing local authorities in British Columbia and Alberta. The New

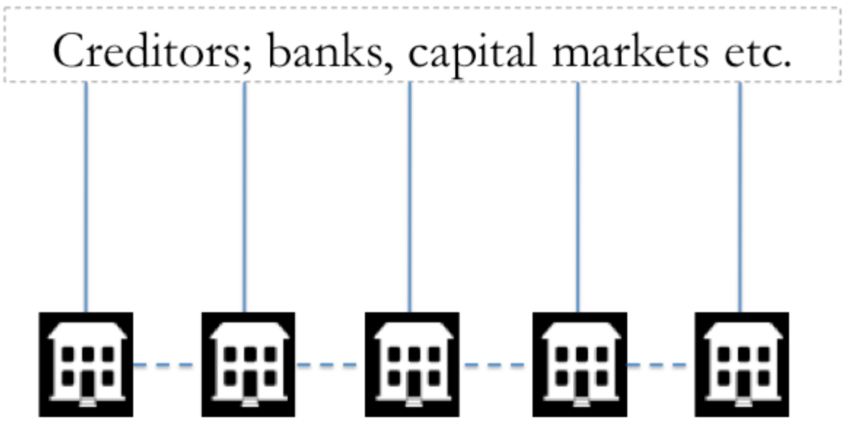
Zealand LGFA was created in 2011 and, recently, the Australian state of Victoria has formed their Local Government Funding Vehicle.

Also in emerging and developing countries, pooled financing has been developed. One example that is often described is the Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL). On the contrary to most other PFMs this is a Public-Private Partnership. It is promoted by Government of Tamil Nadu with equity participation from banks and financial institutions. TNUIFSL has a wider scoop of activities than for example the European LGFA, since its staff also acts as consultants and investments advisors.

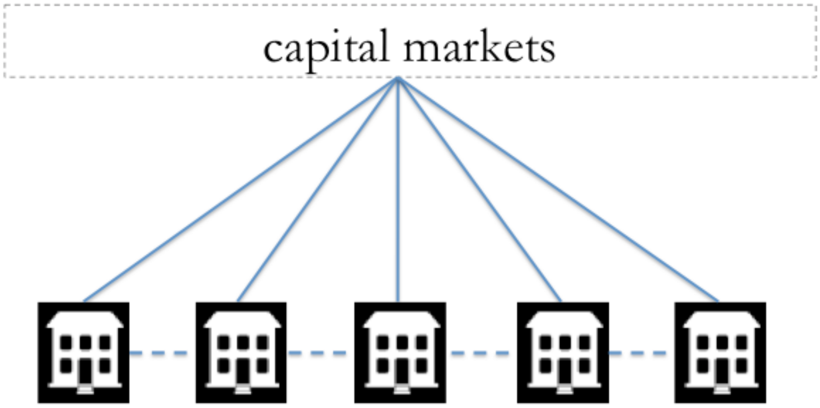
The existing PFM agencies in USA and Europe have to a large extent focused on the liability side of the balance sheet. In other words they have supplied the involved cities with cost-efficient funding for their investment. In order to meet today's and tomorrow's challenges, more needs to be done. It is also a question to wisely choose the right investments that efficiently fulfil local infrastructure needs and counteracts climate change. Already, we see a trend that agencies increasingly issue "green bonds". But the agencies also need to assist the participating cities on the asset side of the balance sheet. I propose an extension of the mission to include assistance in performing feasibility studies of planned projects and to prioritize between them.

Stages of PFM

PFMs can be constructed in many different ways. As a first step a group of cities can coordinate their borrowing activities and exchange best practises. This can include using similar procurement processes in relation to banks and other creditors. There are cases when neighbouring local authorities have agreed on a joint head of finance to further coordinate the financial questions.

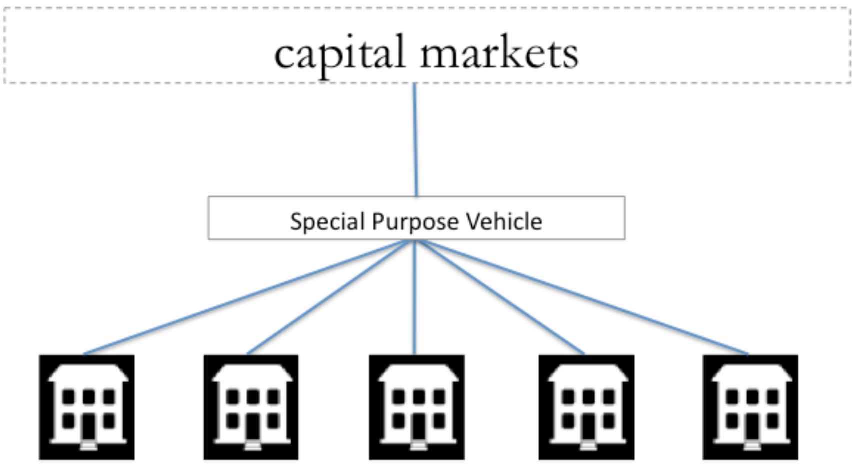


A second step, which was used before the creation of the French agency, is a club deal. This is a bond issue with two or more cities participating and it is done without a special purpose vehicle. Each participating city is responsible for their part of the payment of interest and capital.



A third step is to create a special purpose vehicle (SPV) to act as an intermediary between the cities and the capital market. The big advantage with a SPV is that it can reach sufficient volumes in its borrowing need to diversify its funding operations and achieve cost-efficient pricing in the capital markets. Diversification also means reduction of risk in the manner that the SPV is not reliant on one source of funding or even one market. That a SPV has the possibilities to employ financial experts to run the operations also reduces the risk.

This kind of entity has to have the economical strength to be credible to investors. Economical strength, which in this case is the same as creditworthiness, can be gained through sufficient capitalisation and reinforced by guarantees. The guarantors can either be the participating cities, central government, a third party (e.g. public sector pension funds) or a mix between these. The advantage of having a guarantee from the participating cities is that it reinforces the local responsibility for the SPV.



Professionalism, transparency and local democracy

A fully developed PFM with a SPV is a public tool for local development and growth. The construction of such an entity is a project for decentralisation and local democracy. Real decentralisation can only happen when local authorities have power over their finances and the access to funding sources for local infrastructure investment. Such powers and possibilities also increase the local accountability for questions concerning local development.

In a situation where central government transfers and bank financing is not enough to cope with the growing need for local investment, PFM has the potential to give access to capital markets. This is a route to cost-efficient financing, which has been proven by all of the existing PFM agencies.

A PFM agency has to apply a high degree of transparency for a number of reasons. Firstly, the capital markets will require full disclosure of financial information of the agency and participating authorities. Secondly, the most important asset of a PFM agency is its creditworthiness. It is build upon the creditworthiness of the participating cities, which is why the financial status of these has to be monitored on an ongoing basis. It is also essential that the agency is transparent and issue comprehensive reports of its activities to the benefit of the involved cities and other stakeholders. This means that financial information has to be freely supplied by the cities in the PFM. A large part of this information will be public, which means that it will enhance public understanding of the authorities' activities and thus support local democracy.

A fully developed PFM agency has also the potential to reduce risk in the following ways:

1. Prudent asset-liability management and liquidity policies. This means, among other aspects, using structured financial products only for hedging purposes in their funding and to totally refrain from so called "toxic loans" in the lending. Matching of the duration of assets and liabilities is important, especially in the first phase of activities of an agency.
2. Diversification of borrowing with the use of different markets, different instrument and targeting a number of different investor groups. When, for example, one market is not functioning well, there are others that will be targeted. The diversification of funding was one of the major reasons why the existing PFM agencies were not hit by the recent financial crises.
3. Professionalism, where the political decisions are separated from the professional. In a PFM agency the political level should be dealing with questions related to overall strategy, questions related to the participating local authorities (capital, guarantees, supervision etc.), follow-up of the professional level, while the professional level duties are to prepare the questions for the political level and handle all financial activities. This secures, not only low-risk activities, but prevents as well undue influences in the lending activities.
4. Supervision of the cities and local authorities involved, as shareholders/members, in the PFM. This gives incentives to improve local creditworthiness through peer pressure, which has often proven to be the most efficient way of improving local performance.

Furthermore, PFM schemes can transfer knowledge to the participating local authorities. The existing PFM agencies organise on an ongoing basis conferences, workshops and consultations.

It should also be stressed that PFM agencies are strongly recommended to work in open competition with other suppliers of loans to cities and other local authorities. The PFM will in that way constantly have to prove itself and its usefulness.

Conclusion

The use of PFM has not only the potential to supply cost-efficient funding for local infrastructure investments, but also increases transparency and facilitates capacity building in local authorities. The creation of PFM schemes is always dependent on the specific circumstances in each country. And there are many ways to organise PFMs, from a first step of cooperation to the creation of a special vehicle or agency. Although PFM structure can and should be built in steps, my opinion is that the final goal should be to develop a fully-fledged agency that not only supply financing but also assist in the prioritisation of investment projects. This means that these entities would assume the role of local infrastructure development agencies, which would, together with the cities and other local authorities, have the important role of facilitating efficient and resilient local infrastructure investment activities, with the potential to promote growth in the country in question.

Lars M Andersson

Lars M Andersson initiated the creation of Kommuninvest, the Swedish Local Government Funding Agency in 1986, and became the agency's first president. He developed its operations until 2001.

During the last 20 years, he has worked as an advisor to local authorities in many parts of the world; recently, in projects to create Municipal Bond Agencies in France and the UK.

Lars M Andersson is a member of the Supervisory Board of Agence France Locale and chairman of the Strategy Committee within the agency's board. He is also a member of the Board of Fonds mondial pour le développement des villes (FMDV, *Global Fund for Cities Development*) and chairman of Kommuninvest's Research Fund Committee.

Phone: 0046705911789
Web: www.maproductions.se
Email: lars.m.andersson@maproductions.se
Twitter: @LarsMarten