COST DEFINITION AND RECOVERY FOR INFRASTRUCTURE, LAND AND PROPERTY

The presentations of cases from a variety of localities are specific illustrations of urban development, achieved through different types of institutional and financial arrangements. Many of these can be characterized, in some way, as public-private partnerships. Indeed, it is probably true to say that most urban development activities have always been concerned with partnerships between the public and private sectors. Currently, however, much more emphasis is being placed upon the potential for an expansion of the private sector role in these activities, with a corresponding scaling back of public sector involvement. Although different types of institutions are involved, they have a common concern with financing. Thus, the various cases can be perceived as specific examples of generic financial paradigms, mainly relating to public sector facilitation of private sector activity.

As part of the issue of public-private sector cooperation, it is important to look at institutional financing generally, distinguishing among: cash-flow; profitability; and project development. Cash-flow is normally of most immediate concern. It relates to survival: from meeting current payrolls to keeping contractors at work on urban development projects. If necessary, cash must be borrowed - often short-term at high interest costs - to ensure financial survival, because delays are almost always expensive. Nonetheless, for medium to long-term sustainability, cash-flow, though necessary, is not sufficient. It is essential that an enterprise or entity be profitable, covering all costs in terms of economic resource consumption, including capital costs. This must be done either from commercial charges or from other financing sources. Finally, development projects almost always require the injection of new capital into the entity or enterprise, whether public or private. This will typically be from debt, grant or equity, thereby permanently changing the capital structure. In other words, development projects tend to disturb the financial stability of an entity as a going concern.

The standard paradigm for any development project is that capital is invested to produce long-term assets. These are either used or disposed of, so that the proceeds cover the costs of operation, maintenance, administration and taxes, together with recovery of capital investment costs. The latter comprise fixed asset depreciation (return <u>of</u> capital) together with interest, dividend or retained earnings (the return <u>on</u> capital). The revenues to recover the entity's costs may come about directly, from rental or sale of the property engendered by the project. This would apply, for example, to a project concerned with urban site development. More indirectly, the revenues may come from the sale of goods and services which the project property helps to produce. This applies, for example, to the provision of assets for urban infrastructure, such as water supply, sewerage or urban transport.

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Even though some economic and financial efficiencies may be obtained through better management or contracting arrangements, recognition and coverage of full costs, either from direct revenues or from public subsidies, is inescapable. Moreover, at least in principle, if project assets are to be used only for revenue-earning, in a profit-maximizing manner, they can often be provided, managed and disposed of entirely within the private sector, with no direct public sector involvement. Public sector activity then consists largely of regulation, either to mitigate market failures or to impose socially-relevant constraints.

In practice, almost inevitably, within the framework of urban development, there are a number of concerns which require public sector intervention. First, there is the need for provision of long-term basic utility infrastructure, which the private sector may not be interested in carrying. Second, there are social concerns, such as in the provision of collective goods and other public services, the costs of which will not always be fully recovered from user charges. This may be either because it is not feasible, such as in the provision of public goods, or because it is considered socially undesirable or inappropriate, such as in the provision of housing for low-income occupants or urban transport. Third, private urban development will create external costs upon the community, such as environmental and social heritage costs, which are not directly borne, through the market mechanisms, by the private sector operators. Finally, the there is almost always a need for the public sector planning authorities to impose spatial and temporal order and discipline, as well as health and safety requirements, upon the development process, if necessary though exercise of coercive powers. This control represents a public good, in the interests of the entire community, but for which individual developers may be typically unwilling to pay, at least through normal commercial markets.

For these various reasons, although the overall costs, including economic externalities, are inescapable, the financing of public-private partnership arrangements will typically provide for some of them to be partially borne otherwise than directly or immediately through market mechanisms. The financing arrangements are sometimes, therefore, directed mainly at providing more flexible cash-flows than may be possible solely with commercial market systems. These cash-flow arrangements will typically involve subsidies, from either public or private sources, with responsibility for public subsidies shared between the local communities and the state or national governments.

Private sector subsidies, in principle, sound implausible. However, they may sometimes be derived from: coercive powers of government; well-motivated voluntary activity; or contractual obligations. Coercive power is typically exercised as compensation for (or as complementary to) the provision of orderly development, through the spatial planning (zoning) process. It sometimes results from requirements that private developers pay a linkage fee (through a formal exaction or proffering process) in exchange for planning permission on a particular site. It is also quite customary for a site developer to provide some or all of the on-site infrastructure, to be vested in the appropriate utility or government for subsequent use, operation and maintenance.

If a developer has entered into some form of public-private partnership agreement, initially involving the provision of public assets - such as free or subsidized land - the contractual arrangements may well provide for a sharing of profits, derived from the ultimate enhancement of land values upon project completion.

Private corporations may also make voluntary contributions - usually in cash, but sometimes in land or other assets - towards public sector activity, from a variety of motivations. Overall, there may be a recognition by a corporation of its responsibility as a member of the local civil society and social discourse. More commercially, contributions may be made to: enhance public image; assuage social conscience; or, provide early, urgent and necessary financial assistance to the public sector. This may be, for example, in exchange for some agreed or expected concession at a later time or on another site. Alternatively, it may be in a developer's commercial interest to expedite the development of a site (or provision of infrastructure), to avoid its own costs of delay or disruption.

Increasingly, commercial corporations may combine their financial resources to establish a "business improvement district." Motivated by a common concern to enhance the overall attractiveness of a commercial area, such as a mall, central business district or industrial zone, the business improvement district may make collective contributions for the enhancement of (say) cleaning, safety and security services, together with aesthetic attractiveness. These will typically be provided to a higher standard than those commonly provided from general local taxes, either by the establishment of special arrangements with the local government or by the use of private contractors.

Individuals within a community may also, in certain circumstances, make contributions to public-private partnership arrangements. These may be in the form of monetary donations or voluntary service. In more limited circumstances, especially with the provision of (say) local social services (such as park or playground maintenance) or tertiary infrastructure, it may even involve voluntary physical labor, the classic "sweat-equity" situation. As with businesses, contributions may sometimes be pooled, for the common good. Sometimes, this will be by relatively informal "community partnership" arrangements. Alternatively there may be a "community development corporation" or similar formal corporate entity.

Where contributions come from state or national governments, they will often result from funding provided under legislated programs, directed at specific social concerns, such as low-income housing, urban transportation, environmental concerns or social heritage restoration. There may also be funds of a more flexible nature, such as block grants to local governments, to use with more discretion. Finally, local governments themselves, with the most immediate interests in the local urban development process, must often be seen as a major and residual source of subsidy funding.

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If the concept of subsidy - from cash, voluntary service or asset donation - has been clearly established and implemented, the actual funds may be used in two principal ways. First, capital grants or concessional loan funds may be used, as complements to market-based borrowing or profit-seeking equity, to lower the average cost of capital for the provision of physical assets. This, in turn, will lower the annual requirement for debt interest and (provided there are also adequately long amortization periods) provide for a reduction in overall debt service requirements. If, in addition or instead, subsidies are provided on a periodic annual basis, these may well be used, as complements to user charges, to contribute towards overall annual operating expenditures.

When lower debt service requirements are combined with a lowering of net expenditures for operation and maintenance, this reduced cash-flow obligation permits the possibility that at least some of the operations of the public-private partnership be provided at lower than market costs. In other words, not all the costs will be needed to be directly recovered, in full from users, through market prices. This provides the flexibility for subsidy components to be directed at social, environmental or longer-term developmental concerns, for which full market pricing may be inappropriate.

However, in the prevailing economic and political climate, significant cautions are appropriate. First, the fact that either capital or operating subsidies make it <u>possible</u> for user charges to be lowered - for selected or all users - does <u>not</u> mean that they should be. Subsidies, from whatever sources derived, will almost always be limited. Moreover, they will likely be hotly contested, politically. Thus, it is essential that they be well-targeted, so as to benefit, as far as is feasible, only those persons or activities intended.

In principle, costs should be recovered in full, by market-based user charges, with subsidized charges being regarded as <u>exceptions</u>. Moreover, for each situation where subsidization appears appropriate, there should be careful examination and justification, from perspectives of economic efficiency (such as correction or mitigation of market failure), social equity and overall public policy. In particular, where a public-private partnership allows and facilitates the earning of profits by the private sector partners, this should be encouraged and sustained. Misguided attempts to unfairly limit profits for reasons of perceived unfairness may not only be unjust, it may also be economically inefficient. As a result, it may even drive private participants away from a project or activity or discourage them from further participation.

A second caution relates to the fact that subsidies can lower prices. Thus, following normal economic principles, more will be demanded of a good or service than if it were fully charged for. It should, therefore, be ascertained that public policy makes it appropriate for the provided good or service to be financed in this way, usually to correct a market failure or to deliver a needed public or collective good.

Where capital grants, or concessional credit, are involved this may also engender policy failures. For example, faced with the full costs of maintaining a partly worn-out asset, or of replacing it (too early in its working life-cycle) with concessionary capital funding, public sector policy-makers might choose the less economically-efficient but more financially-attractive option, thereby reducing the availability of capital for more urgent purposes.

Urban development activity will, almost always, affect the real values of land. Therefore, it is important to ensure that any likely betterment of land values be equitably shared between the private and public partners. However, although provisions for sharing the profits from land values may be included in the contracts, in practice the changes in such values can be very speculative. Furthermore, because of the time element, economic buoyancy may change dramatically between the start of projects and their final completion and realization. It is, therefore, important that contracts for the sharing of land value increments be drawn in a flexible fashion, providing a methodology for allocating values fairly under a variety of economic circumstances.

Urban development is a process subject to much disruption and delay. This, moreover, exacerbates the costs of carrying unfructified assets, often installed at significant initial cost. In particular, all delay, between initiating the creation of assets and their final use, sale or disposal, incurs interest costs. These, in turn, add to the overall costs of capital, thus nullifying, to some degree, the advantages of the capital subsidies. Unfortunately, because the capital may be subsidized, the overtly perceived impact of the interest costs will be mitigated, reducing an obvious and immediate financial pressure to expedite development.

Nonetheless, as already indicated, the full economic costs of disruption or delay will impact somewhere in the system, albeit not readily apparent from (say) the financial accounts. This places an additional managerial responsibility upon project managements to ensure that the installation of costly infrastructure, which is complementary to site development, be carefully phased, within the constraints of scale economies. This is so that delays do not create undue economic burdens, by diverting capital funding from more urgent opportunities, as well as raising overall project costs. This, in turn, can only lead to higher user charges, greater levels of subsidy or - more unfortunately - misguided efforts at cost-saving, such as scaling back or delay of preventive maintenance.

Therefore, with respect to large and time-consuming urban land development or infrastructure projects, it is important to ensure that the on-site infrastructure installation be carefully phased, providing only that which can most promptly and efficiently be used by complementary development of superstructure or operational assets. This, of course, requires attention to the possibilities for full and prompt capital financing of the superstructure, as well as of the infrastructure. It also necessitates an adequate marketing strategy for the commercial or public use of completed buildings. Alternatively, it requires well-developed forecasts for the sale or use of the goods and services delivered by infrastructure.

In the past, it had often become customary for the costs of public services to be hidden among different accounts, budgets and funds. However, this did not usually derive from deliberate intentions to deceive. Much more commonly, it arose from the mere following of complex and fragmented administrative, policy and financing arrangements. Typically, for example, capital costs would often be completely separated from those of operation, maintenance and administration, so that user charges or subsidies would ignore the fact that large infrastructure projects would have been funded by huge government grants. Transportation projects are a prime example.

Currently, much public sector activity is being taken over, wholly or partially, by the private sector. Even where the public sector continues to operate public services, it is increasingly being held accountable to perform in accordance with commercially acceptable standards. Thus, a primary concern is for full and complete costs of projects or services to be clearly ascertained and reported. Unless this is done, economically efficient sale prices, rents or user charges cannot be set - nor, where they are appropriate - can subsidies be clearly identified, appropriately applied and justified.