MUNICIPAL GOVERNMENT

AND

PUBLIC UTILITIES

FINANCING AND MANAGEMENT

OF

PUBLIC SECTOR INFRASTRUCTURE

By

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Overall Financial Requirements

1. From the overall perspective of various entities dealing with public utilities and infrastructure, it is clear that in many situations, world-wide, future demands on public financial resources will be formidable. This will apply to the funding of ongoing public services as well as capital investment.

2. For example, in many situations, road-space, drainage and sewerage systems are totally inadequate to deal with even the current needs of residents. Underground piping is, also, old and worn. The development of new residential and commercial areas typically demands large inputs of primary infrastructure. Where cities are, as is quite common, located astride rivers, there is also need for substantial upgrading of river crossing facilities. This becomes exacerbated by earlier concentration on one side or other of the river, subsequently overtaken by needs to develop the opposite side, also.

3. Where underground rapid-rail systems are planned, or under construction, capital financing requirements will be huge. There is also no assurance that subsequent operation and maintenance will not require significant annual subsidies.

4. In addition bus, streetcar, gas, electricity and water supply services often operate under policies dominated by public welfare considerations. Thus, prices are inadequate to cover operation, maintenance and capital-cost recovery. As a result, the recurrent budgets of municipal governments must often provide for heavy annual subsidies.

Basic Financing Principles

5. The search for alternative financing of public services and infrastructure should clearly explore possible new approaches. In particular, there may be considerable potential to use leasing, sale or grant of concessions for publicly-owned land, in exchange for private sector financing of public infrastructure. Indeed, it is likely that some attractive packages can be arranged, with both local and foreign investors. It should be cautioned, however, that the search for innovative financing should not overshadow the need to apply some well-known and commonly-used principles. These, valid in most situations in the world, must be the inevitable fall-back positions, if more creative options are not available.

6. Most forms of capital financing, however creative, fall into two main categories. Sometimes, as in the case of share capital, it provided by those who are in an ownership position. They are prepared to accept the residual risk of operational failure, in return for a speculative expectation of profits, if successful.

7. Stockholders, in return for this risk, expect and demand a role in the decision-making process of the entity. They are, in fact and in law, its owners and managers.

8. If ownership rights are not granted, perhaps as a matter of public policy, the only other recourse is to some form or other of borrowing. Effectively, this is by security against either real property or financial revenues. Otherwise, it is based on the full faith and credit of a public institution. It relies, in this latter case on its power to tax. Borrowers, however, in exchange for their contractual rights to specific returns, forego rights to normal decision-making power, within the management of the entity.

9. In principle, the expected return by a borrower is a "rent" for the money loaned. This may be in the form of annual receipts, usually in the form of interest, or capital appreciation. The latter, effectively, is the compounded value of all periodic rents foregone in the meantime. Examples would be bond appreciation or a share in the increased value of a real asset, such as land.

10. As with ownership capital, the expected return is based on risk. However, the risk assessment recognizes that all obligations to borrowers, however onerous, must be met before any rewards are paid to the ownership interests.

11. However, despite the legal situation, an interesting practical anomaly arises for "public sector" institutions. If private stockholders hold a controlling interest in a publicly-owned company, they are, effectively, its owners. Any capitalization then coming from public sources represents taxpayer funds invested in a private entity. This is counter to the normal expected use of such funds.

12. Alternatively, to the extent that the ownership rights of the private majority shareholders are legally curtailed, they are really no more than lenders. This is also the case if they are minority shareholders, because then the effective and over-riding decision-making power is in the hands of the public sector.

13. The basic principles of capital financing may be summarized as follows:

a. long-term borrowing - or its equivalent - should be confined to the financing of investment in land, buildings, permanent works and equipment, intended to provide a future flow of benefit to the community;

b. borrowing periods should be related, as closely as possible, to the working lives of the assets to be financed and to their ability to efficiently deliver the future benefit flows[1];

c. long-term loans should be fully repaid, together with all interest, within the working lives of the assets financed; and,

d. all expenditures relating to the current delivery of public services, including operation, maintenance and debt service on fixed assets, should be met, on an annual basis, from stable and growing sources of local revenue.

14. From this, it follows that municipal governments and public utilities must continuously operate within the framework of a balanced recurrent budget. Furthermore, the various revenues used to bring the recurrent budget into balance must exclude revenues from sales of land and other public assets.

15. They must also exclude other one-time financial inflows, such as capital grants and donations, public utility consumer (hook-up) contributions and receipts from the disposal of public enterprises to commercial or private interests. All these funds flows will be of a "windfall" nature. These should, therefore, be reserved for capital expenditures[2].

Public Sector Institutions

16. Based on its observations of institutional performance in many places, it is possible to contemplate a number of options for service delivery entities, within the jurisdiction of a municipal government. The distinctions among them largely relate to the extent to which the services provided will be (wholly or partly) directly revenue-seeking or tax-borne.

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[1] It is often just as financially imprudent to finance long-life assets from short-term loans as to borrow for too long a period. It creates additional burdens on current finances, not justified by the longer utilization of the assets, but inevitable unless the loans can be rolled over or refinanced. This may preempt more important and urgent recurrent expenditures. Because short-term financing is often more readily available than that for longer terms, it creates a great temptation for municipal governments to rely upon it too heavily.

[2] By contrast, the United Kingdom government credited the proceeds of its privatization activities to its recurrent budget. This practice was severely criticized by many public sector financial specialists.

17. The options sometimes postulate the possibility of some form of corporate structure, to some degree separate from the overall administration of the municipal government. This has one important advantage, in virtually all situations. It allows the setting, by the national or municipal government, of a specific set of concerns to be addressed by each individual entity. Against these, it can be held accountable for both financial stewardship and operational performance.

18. The formulation of a corporate structure for each set of objectives offers the opportunity that the activity of each autonomous entity will be substantially immune from the likely changing political agendas of the core governance function.

19. However, the establishment of a corporate structure for wholly or partially autonomous operations is not necessarily consistent with the concept of the private "joint stock company." This is frequently referred to in discussions on restructuring of state owned enterprises. Instead, a circular set of arrangements can be perceived, as shown in Annex A. They concern: financial markets; ownership; control and management; and, institutional structure.

20. First, capitalization from financial markets does not necessarily provide for <u>effective</u> ownership. Such capitalization may come from bonds (lending), rather than stocks (ownership). Furthermore, the issue of different classes of stock may result in the trade-off of decision-making power for security, as in the case of so-called "preference shares." Finally, holdings by minority stockholders may endow them with only nominal (legal) ownership, with no effective control or management.

21. Thus, in the "Western" system, if there is really no intention to give effective ownership to investors, as in the case of <u>publicly owned</u> utility corporations, virtually all capitalization is from bond issues.

22. Second, legal ownership, through stockholding, does not necessarily, imply effective control or management. Apart from the potential ineffectiveness of minority stockholders, it is virtually impossible for the stockholders, as a group, to manage the day-to-day affairs of the corporation.

23. This function must be delegated to a board, which may, in turn, be dominated by the chief executive and managers. Neither the board nor the managers will necessarily have identical goals to those of the (stockholder) owners. For example, the principal goal of the stockholders may be that of profit, whereas the personal goals of the chief executive - especially if not a substantial stockholder - may concern benefits and "perks."

24. Furthermore, where the public interest is present, the pure profit-seeking motive of the stockholders may be significantly over-ridden by regulation, of either operations or prices. This is particularly true when dealing with activities which are considered as "natural monopolies."

25. Third, autonomous control or management need not necessarily imply the use of a corporate structure - and certainly not in the "joint-stock" form. In the public sector, there are many other forms of delegation to individual entities. These may range from the establishment of quasi-independent government departments or operational units (such as schools, hospitals or colleges) to wholly-owned government corporations, with no private stockholding and no intention to create it.

26. Finally, a financially autonomous corporate structure may not necessarily imply the use of capital-market financing. It is quite common for public assets, within publicly owned autonomous corporations, to be wholly financed from direct government loans or grants. Thus, the "equity interest" of the government is often merely a formal, legal, artifact.

27. In summary, therefore, the establishment of financially autonomous entities, for the delivery of public services, offers a range of options which might be substantially different from what is commonly now known as "privatization." Some might involve corporate structures, some not.

28. Thus, policies of institutional restructuring should be evaluated not only with regard to a set of given objectives but also in terms of how those objectives might be achieved in alternative ways. It is appropriate, therefore, not to regard "privatization" as a panacea. Instead, it should be regarded as one of the tools, albeit an important and powerful one, for fulfilling the political and operational objectives of a local, state or national government.

Contracting-Out of Public Services

29. There is an alternative to the delivery of all services by the employment of direct labor by public sector institutions. Many activities offer opportunities for contracting, by open competition, for such services to be provided by enterprises outside of the direct control of a public entity. This could apply to both core governance activities, as well as those provided by autonomous enterprises.

30. The normal "Western" practice would be to allow the public sector "direct service" units to participate in the tendering, after being formed into quasi-independent "direct service organizations." An essential feature of such re-structured units would be the establishment of cost-accounting systems which are consistent with those of outside contracting entities, to ensure fair competition. This arrangement often leads to the "internal" entities actually winning and performing the contracts but with the added advantage of doing this under competitive conditions.

31. For such a system to work consistently, it must result in improved productivity in service delivery - in the sense of more service for lower unit cost. Thus, opportunities must be present for the public sector to save on costs - otherwise there would be no incentive to "contract out." It is also necessary for the commercial enterprise to earn profits - otherwise, there would be no incentive to tender.

32. Often, the savings and profits come about as a result of improvements in labor productivity. Whether or not this is always shared by workers, in terms of improved benefits, is often one of the more contentious issues. There is no shortage of examples of "contracting-out" where major "savings" to the contractor have been as a result of paying lower wages, to less-skilled staff. This then results in delivering a lower standard of service to the public.

33. It is usually appropriate for "contracting out" to be approached gradually. Furthermore, it is often most useful to divide work in such a way that it can be delivered by several commercial enterprises, in competition with one another. If this is not done, there is a greater potential for a single commercial contractor to develop monopoly power of its own. This, it can do by gradually developing an incumbency position, especially by preempting the public sector's ownership of essential equipment.

34. For example, if the garbage-collection service were to be fully "contracted-out" by (say) a municipal government to a single - or very few - commercial enterprises, these would, after a short time, own all the essential vehicles, plant and disposal sites, leaving the enterprises with a significant tendering advantage.

35. Furthermore, the importance to a commercial enterprise of consistently winning the contract could make it vulnerable to "trade union" type pressures from its own work-force. The result could be the shifting of most of the cost-saving advantages away from the public sector, into the pockets of either workers or commercial enterprises.

36. An additional cost, sometimes claimed in economic writings, is that referred to as "directly unproductive profit-seeking." This postulates that the advantages of obtaining a complete or partial monopoly on the delivery of public services makes it seem advantageous for potential contractors to employ lobbying and other methods of influence, not all or always ethical. These have social costs in themselves. Furthermore, to those who win - as well as to those who fail - to win a particular contract, their expenses may represent a dilution[3] of the intended tangible gain to the public by shifting some of the net benefit elsewhere in the economy.

37. Finally, with "contracting out" the public entity often cannot divest itself of the ultimate responsibility for efficient public service delivery. Thus, it will retain the risk that it will receive less than adequate service from its paid contractor. This, it will either have to remedy, at further public cost, or else allow the public to suffer the inevitable shortcomings. In "Western" systems, the enforcement of either financial penalties or performance obligations against recalcitrant contractors often proves costly, time-consuming, contentious and ineffective.

38. One important cost of "contracting out," often overlooked, is that of contract administration. The employment of many individual contractors will pose different management concerns to the service delivery entity than those for direct labor. The means to address these concerns need to be learned, gradually and by experience. As the learning process results in improved managerial productivity, administrative costs of "contracting out" will gradually fall. However, if an increasing number of contracts are entered into, the overall administrative costs will, clearly, rise.

39. As these costs, overall, become material, there will be an ever more urgent need for them to be accurately and appropriately accounted for. Furthermore, in assessing the net benefits from the use of contracting, extra administrative costs must clearly be off-set against the direct productivity savings in service delivery. Thus, the net benefits will arise only after all contract administration costs are fully allowed for. This raises another important concern about accounting. The costs of administrative overheads may well not be fully recorded in the accounts of the government in ways which enable it to clearly identify the total costs of the contracted operation.

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[3] This shift arises because there could be less real direct economic gain to the municipality and its public. Instead, there might be a shift of money to the lawyers, lobbyists etc. who would then reap the related economic benefits. This contrasts to original expectations of the "contracting-out" arrangements, whereby direct economic gains to contractors, after deducting losses which might be suffered by (say) direct public employees, would result in greater net benefits to the local public.

40. In summary, therefore, public entities should exploit opportunities for alternative methods in the delivery of services and the performance of public activities. They should do so, however, not as seeking a panacea but with a prudent balancing of productivity improvements against risks, safeguards and administrative costs.

Public Borrowing - Control and Allocation

41. It is clear that the financial resource needs for public utilities and infrastructure will require significant borrowing. This will demand that attention be given, at the highest level of any municipal or other public sector entity, to suitable systems of control and regulation of borrowing, throughout the entire financial management domain under its control.

42. Prudent financial management practices predicate that all public sector borrowing, for whatever purpose and by whatever subsidiary public entity, be brought firmly under the control of the central financial management function of the entity. Thus, the "Director of Finance" will need to take a leading role in the allocation of loan resources and in providing for guarantees of loans raised by or for the various entities.

43. This is of crucial importance when the borrowing is for services which will be wholly or mainly financed from general revenues, including taxes. It applies whether these revenues are used to finance the direct governmental functions of the municipality or - absent any ability or willingness to cover costs from charges - as increases in public utility subsidies. This could be especially burdensome, for example, for new rapid-rail or similar transportation systems.

44. Unless there are efficient and effective financial markets, it may well be necessary for central governments to establish or adapt a centralized financing entity through which to channel all or most of its public borrowing.

45. For example, there might be the establishment of (say) a "Public Works Investment Corporation." This could well be designed to function as a "Consolidated Loans Fund," or "Capital Fund." Alternatively, it could manage such a fund, in addition to other activities and obligations.

46. Such a fund would raise all public debt for the governmental, utility and infrastructure functions of the local governments, on whatever terms and conditions were available in the market-place. It would then re-package this debt, so as to lend to the various municipalities or operational entities.

47. This would be in exchange for obligations to service the principal and interest obligations, from either operational revenues or budgetary allocations. For a particular entity, this obligation would need to be undertaken in close consultation with the Director of Finance, to ensure that long-term charges on general revenues be given priority over new expenditures.

48. There are now many situations where nations and communities are emerging from "planned" to "market" economies. For them, an important feature in re-structuring the debt-management function of the municipalities or public utilities will be a shift of emphasis from an "allocative" approach to a "contractual" one.

49. Lenders, in the public market place, must be assured that their debt service entitlements will be met in full and on time. Public service entities, in turn, must be aware that they will be held ruthlessly accountable, from their annual budgets, for the full allocation of debt service obligations, either directly or to a "Consolidated Loans Fund." Indeed, such a debt-management approach will require that all parties view obligations as virtually "not negotiable."

50. To facilitate the allocation of borrowing and other capital-financing resources against priority projects, it is necessary to establish a centralized project appraisal capability. This could well be formed as part of (or as an adjunct to) the "Public Works Investment Corporation." It will need to use criteria which will be instituted in consultation with (or prescribed by) the national Ministry of Finance.

51. Indeed, even though the borrowing and appraisal activities may be carried out within an Investment Corporation, it will often be important for the Ministry of Finance to exercise an oversight and audit function. This accords with its responsibility for the allocation of public funds, through the budgetary process.

52. Although the appraisal of capital projects will require guidance, direction and monitoring from the center, the primary responsibility should gradually be delegated to the entities most directly responsible. The process will then form part of the overall planning, programming and budgeting capability which each service-delivery unit should develop for itself.

Public Borrowing - Foreign Exchange Requirements

53. In many countries, some of the capital financing will need to be raised in foreign exchange. This will likely be for the importation of foreign goods and services. However, if domestic resources are inadequate to meet infrastructure needs, it may be that part of the future borrowing - or equity financing - even for locally procured goods and services, will come from foreign sources.

54. In either case, a community's contractual obligations, with respect to its debt service, will extend to foreign exchange requirements. Furthermore, if the value of the local currency deteriorates against the foreign currency of any loan, more local currency will be required to finance the debt service.

55. The public sector activities of the various entities will likely make significant indirect contributions to the earning of foreign exchange. For example, infrastructure improvements will facilitate both foreign trade and tourism. However, these activities will not generate foreign exchange directly. Thus, it will be necessary for the debt servicing entities to have access to foreign exchange earnings of the commercial sector. This will either be by contracts with commercial enterprises or - more likely - through the national banking system.

Public Borrowing - Financial Markets

56. To ensure the most economical raising and use of public funds for infrastructure development, it will be imperative for financial markets to develop and sustain a significant capacity for the raising of funds. A large proportion of this funding will likely be in the form of bonds, rather than equity, consistent with the wish of many public sector entities to retain effective ownership in the hands of government.

57. A most important feature to develop in the financial market, for both public sector and commercial financing, is that of trust. Investors must develop confidence that borrowing entities have the competence, sincerity and reliability to service their debt responsibilities.

58. This means that the financial market-place be provided with reliable information, which can be so assessed by independent bodies. These will comprise the regulators of the financial markets, as well as those with a fiduciary duty to the investing public, such as auditors, underwriters, issuing houses and rating agencies. Such bodies, where not already existing in an adequate form, will need to be established, upgraded or improved.

59. As already indicated, the sums needed to finance the services and infrastructure of many communities are formidable. Thus, the quality of the administrative management of the financial market-place, will need to be matched by an adequate expansion and sustainability of its capacity to raise the required sums of capital.

Investment Financing - The Competitive Environment

60. Competition for investment capital will largely be based on perceived risk and return. For public sector bond issues, this will depend upon the interest rate, combined with the reliability and quality of the expected revenue earnings. These will be based on either the expected operational and financial performance of the borrowing entity or the underlying strength of the local (municipal) taxing structure. Thus, sound pricing and taxing systems will be essential, in the promotion of bonds and other capital financing instruments.

61. It can be speculated, also, that there will be competition for funds from commercial activities. This may be significantly oriented towards equities. Based on observations of the behavior of potential private investors in many emerging economies, it might well be that their interests will lie more towards the opportunity for making fast profits than for longer-term goals.

62. This situation may be reinforced by the fact that - under current social safety nets - investors will perceive that their basic long-term needs are provided for[4]. Discretionary funds may therefore be more willingly channelled into "glamour" security issues, albeit for more fickle purposes than for development of infrastructure. The latter, by contrast, may be considered - in the short term - dull and uninteresting as backing for security issues.

63. The commercial market-place will not always provide more economically efficient alternatives to public sector activity. It is, unfortunately, highly speculative. The combination of empty offices and deteriorating infrastructure in (say) the U.K. and U.S.A. is a current testimony to this.

64. It may well be important, therefore, for national and local governments to embark upon programs of public education, to encourage potential investors to channel funds towards public utilities and infrastructure. Costs of such a campaign could well be offset by the refinement of interest rates for public borrowing and increased funding. Both will bring net economic benefits.

65. It is equally important to note that, in a market-friendly environment, the allocation of investment resources will be through investor perceptions of risk and return. Failure to recognize this, resulting in a return to a process of political allocation, will result in long-term economic inefficiency and a significant reversal of any economic reform principles.

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[4] This has a slight parallel in the U.S.A. There, it is claimed, federal insurance of the funds of depositors of "savings and loan associations" permitted a degree of public indifference towards reckless use of such funds by unscrupulous managements.

Resource Mobilization

66. Competition for funds will not be only among opportunities for investment. As nations and communities move further towards a commercial environment, investment demands will compete against consumption opportunities, for both commercial and publicly provided goods and services. This may be all the more pervasive as an emancipated public seeks for immediate satisfactions, in the form of increased enjoyment and reduced suffering - relative to both inconvenience and privation.

67. These attitudes, combined with the availability of savings, will determine how much funding is available for the different claims of public, commercial and private sectors.

68. An important aspect of resource mobilization, as well as mitigating demands on general public revenues, will be through the use, where possible and appropriate, of economic efficiency prices, such as for public utility services. An essential part of any public information system will be to encourage the economic signals to be given by prices. In other words, a most effective way to get the attention of the public will be to charge full prices for services.

69. The only significant opportunity for coercion, in these circumstances, is that common in all market or controlled economies - adjustment in the level of taxes. Inevitably, local taxes will need to be set high enough to cover all recurrent public expenditures, including the service of debt.

70. The chosen levels, of both taxes and charges, will have both political and economic limits on the public capacity to bear them. This will also affect the level of sustainable capital investment, public and commercial.

Public Sector Financial Management

71. The economic reforms now being undertaken in many countries will likely lead to:

a. a tightening of the allocative process;

b. a need for fuller public information to support investment financing; and,

c. increased importance of financial reporting, accountability and control.

72. These, in turn, will require much greater attention to financial management. Thus, accounting, auditing, budgeting and financial control practices will all require enhancement, throughout the governmental and operational entities of all communities. A key factor is to introduce a budgetary system which separates capital expenditure (and its financing) from recurrent revenues and expenditures.

73. Improvements in overall accounting and financial management systems will be necessary ingredients in a more transparent and open system of accountability for stewardship of funds and in the performance of activities. However, more is required.

74. Directors of Finance must also concentrate attention on the development of management accounting information, for all public sector activities, whether providing revenue-seeking or tax-borne services. It should be a responsibility of the Finance Department to organize and arrange flows of financial and other information to the operational units, so that their managements may make better-informed decisions.

75. This does <u>not</u> necessarily imply a centralized accounting or financial information system. In organizations of the size and diversity of many municipal governments, this is clearly inappropriate and inadvisable. What it does imply, however, is that finance departments retain and enhance their capability to hold the operational units fully accountable to the community as a whole. This is shown by Annexes B and C.

76. To achieve this, in a decentralized system, requires the development of appropriately standardized procedures which are still flexible enough to allow for the individual operating characteristics of the different entities. It will be important that a Director of Finance provide guidance, support, instruction and some degree of control to operational units, to facilitate both accounting for their managements and overall fulfillment of reporting requirements, to the municipality and its public.

77. The training program of Finance Department officials should include secondment to operational units.

78. One particular feature of the use of management accounting for decision-making is the use of life-cycle-costing. Currently, many assets, such as buses and other operational vehicles, are required to be used for life-spans determined by governmental edict. Often, this has proven to be far too long for economic operation, typically because of high repair costs in later years. The introduction of life-cycle costing would draw attention to the need to scrap or dispose of assets when their continued use is no longer economic. This is but one aspect of asset management.

79. The use of management accounting will also provide information about the use of appropriate technology. For example, one can often be impressed by labor-saving achievements observed in (say) U.S.A., Japan and Western Europe, through the use of high technology equipment. The introduction and development of appropriate technology should be encouraged everywhere. However, there is no assurance that the same blend of capital and labor as used elsewhere will automatically be the best for a particular country or - more specifically - for an individual local community.

Planning, Programming and Budgeting

80. Governmental and operational entities should be encouraged in the use of appropriate procedures for planning, programming and budgeting of their activities, within the framework of an overall performance budgeting approach. Arrangements are also required for both tactical and strategic cash management, including the overall management of debt.

81. It is important, for these procedures to reflect the predicted economic, physical, spatial, commercial, fiscal, population and social changes, especially significant growth or decline. Attention must also be paid to financial commitments which a municipal government - or any of its entities - will be "locked into" over significant time-periods. This would include debt-service and unavoidable subsidy obligations.

Public Utility Pricing and Subsidy

82. Some public utilities operate as natural monopolies. To optimize the economic efficiency of their operations, as well as limiting their demands upon scarce general revenues, all such entities, wherever possible, should be encouraged to charge economic efficiency prices. These should be consistent with full-cost recovery of economic resources and coverage of all financial requirements.

83. Thus, in principle, public utility companies should set charges which are intended to cover operation, maintenance, depreciation (at current values) and a real return on assets, valued in current prices. The entities should also be expected to generate funds from operations to cover debt service and to contribute towards expansion of facilities and plant.

84. Where claims are made for subsidy, on grounds of welfare or financial hardship, these should be carefully evaluated. They should, however, be allowed only where fully justified and can be implemented in an efficient manner. In general, overall subsidy of service delivery systems is vastly more inefficient than the individual subsidy of deserving consumers.

85. This applies to both economic efficiency and equity concerns. Indeed, a poorly-directed subsidy may merely mean that the more profligate (and likely better-off) consumers will (at standard unit prices) receive the highest cash subsidies. Also, effectively, much of these will be income transfers - to those who would pay market prices anyhow.

86. The principal justification for subsidies to <u>entities</u> lies in cases where there are high transaction costs, uncertainties or resentments in directing them to <u>individuals</u>. This may apply, for example, in the administration of "means tests."

87. The situation is different where the direct recipient of the service is not assessed as the sole - or principal - beneficiary. This is an argument sometimes applied, for example, to rapid rail systems, with respect to the diversion of road congestion and air pollution. It, is however, in this case, still very contentious.

88. To the extent that either publicly-owned or commercial enterprises are in a position to charge monopoly prices, there should be provision for the regulation of such prices by independent government agencies. These should have the power to over-ride both the political agendas of government and the pure profit-seeking agendas of the enterprises, after holding public hearings on applications for price adjustments.

89. However, many witnesses seeking to be heard at such public hearings are less likely to be in favor of efficiency pricing than in imposing their private or social agendas, or those of their interest-groups. Thus, it may well be found that the role of an independent regulator must be to ensure that prices are set at levels which are <u>high</u> enough to fully cover costs, as well as to ensure that legitimate equity considerations are dealt with fairly.

<u>Land Management</u>

90. A major asset, available to many developing cities, is the ownership, control or management of substantial public land. This can be exploited in a variety of ways, for the financing of infrastructure. Increasingly, such land will be subject to activity based on commercial valuations.

91. Sometimes, much of the land required for infrastructure development may already be in public hands. This results in significant potential savings, or financing opportunities, over situations found elsewhere, with the majority of required land in private ownership.

92. The more that public land increases in value[5], the more savings accrue to the public sector, in terms of the opportunity costs (or benefits) of its acquisition or disposal. In addition, there are notable savings in the transaction costs of land acquisitions, especially where this might otherwise involve compulsory purchase.

93. For direct funding purposes, receipts from the sales of public land, not required for municipal purposes, can be used for related infrastructure costs. As alternatives to receiving all sales revenues in cash, contracts can be made with developers to provide a part of the sales price in the form of infrastructure.

94. Prime development land is sometimes located in the vicinity of the site of (or intended to be used for) significant public infrastructure, such as a river bridge or a metro station. In such a case, it becomes possible for developers to accept parcels of land, at no cash cost, in exchange for the construction of all the public infrastructure. The rest of the land can then be used for commercial facilities, for the developer's own benefit.

95. Where such exchanges take place, it will be important for them to be properly evaluated and accounted for. Furthermore, as already indicated, such one-time sales or exchanges should not be regarded as part of recurrent revenues. Any cash proceeds not immediately used for development should be reserved for future capital expenditures.

96. One feature of the final disposal of land (whether in exchange for infrastructure or not) is that it will represent the disposal of claims to all future revenues from this land - with the exception of property taxes[6]. It will, indeed, kill the goose which lays the golden eggs!

97. The prudence or otherwise of land disposal - and of its extent and timing - will be influenced by the financial needs of the local government and its entities. This is another reason for careful matching of budgetary requirements to overall development activity.

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[5] This is particularly important where such public land is derived from abandoned or curtailed activities. Examples occur where land occupied by railway yards, shipping or military interests is no longer needed for its earlier purpose. Often, it has become derelict and unattractive, as well as having no public facilities and infrastructure suitable for new development. Thus, its initial value is very low.

[6] Even these may be curtailed or postponed if the land is part of an "enterprise zone."

98. An important point is that as real future land values increase, rents - in real terms - can be adjusted to allow for this. Sale prices, by contrast, are fixed on a "once for all" basis. In the absence of a fully developed land-price information system, it might well be found that early disposal of land is - in real terms - underpriced. This would represent a partial gift to the purchaser, who is, effectively, purchasing the present value of all future real land rents.

99. Where land is not disposed of by final sale, it will, of course, continue to yield rents to its public sector landlord. These, along with other revenues, will be available to the general (recurrent) revenue pool to finance debt service.

100. Where the local government (or a development authority) has the power to grant planning (zoning) permission over privately-owned or rented land, this might be accompanied by a requirement that the owner (user) provide some degree of public facilities, in exchange for the valuable (monopoly) development right[7].

101. This cannot, however, be pressed too far. First, an excessive demand, causing a potential loss to the developer, will cause a backing away from the whole enterprise. Second, land may be sold, by the local government or development authority, with planning permission already included in the price. Indeed, to avoid costly disputes, it is important for both the seller and the purchaser to be certain whether or not this is the case.

102. In some cases, a municipality (or one of its entities) will own land rights in connection with the operation of public facilities. An example would be the air rights over a "metro" station entrance. These rights can, of course, be leased to developers to help cover the costs (or related debt service) on the principal facilities. The extent of this will be facilitated or curtailed, for example, by regulations regarding building height.

103. Finally, when land is in the hands of commercial enterprises or privately owned, it can be subject to property tax, either on the land alone or also on improvements.

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[7] This is known, in the U.S.A., as an "exaction." Sometimes, the state or local law does not permit this, in formal terms. In such a case, the developer will typically make an <u>offer</u> to provide public facilities, then known as a "proffer." In Britain, authorities have had, until recently, only very limited scope to secure developer contributions for infrastructure. The "Planning and Compensation Act 1991" changed that position dramatically. Developers can now be made to bear the costs of infrastructure and community facilities as a condition of being granted planning permission.

104. Even land owned by public sector entities should be subject to tax. This is not, usually, to bring in additional revenue, although the setting of public utility prices to cover such taxes will do just that. What the taxing of public facilities does achieve, however, is to mitigate against distortions within the allocative process of the public sector. In particular, it will prevent hidden subsidies to (say) public utility enterprises which own substantial real property. In addition, taxation of public facilities will indicate the extent to which revenue is being foregone, by retaining them within the public domain.

Environmental Accounting

105. Increasingly, it will become necessary to provide in the accounts of public entities for potential costs to remedy current environmental degradation. This may arise from technologically inefficient operation of current service delivery.

106. For example, if a sewage treatment works is operating without producing adequate effluent quality or disposal of sludge, this may create costs to be incurred in the future. To the extent that these are only delayed - but eventually inevitable - they resemble future "debt service" on current "borrowing." Another example would be future closing costs of currently operating garbage disposal sites.

107. In this particular case, it is ecological, rather than financial, borrowing. However, the future resource demands, from either charges or taxes, will be virtually identical. Tightening of environmental standards will - as a direct outcome - increase the costs of such ecological borrowing.

Conclusion and Recommended Actions

108. It should be cautioned that the means to achieve economic development and reform do not necessarily, or principally, lie in the restructuring of institutions. Furthermore, many of the activities to be undertaken by the municipal governments or development authorities will have to be coordinated with many departments, agencies, bureaus and commissions of central or state government. Indeed, policies of institutional reform and restructuring, including privatization, should be evaluated not only with regard to a set of given objectives but also in terms of how those objectives might be achieved in alternative ways.

109. For example, the conversion of (say) a municipal water company from a publicly owned corporation to a commercially owned one may be less important than a rationalization of its pricing structure. If the latter can be achieved under public ownership, institutional change might be neither necessary or appropriate.

110. However, the public authorities should not use this further opportunity for reflection as merely a means to validate current practices or excuse itself from the need to take effective actions. Clearly, a great deal of institutional, administrative, financial and operational reform must often be undertaken.

111. In addressing overall goals of reform, as contrasted with specific activities or reorganizations, the following should rank as among the most important:

a. mobilization of resources for both recurrent and capital expenditures;

b. identification, exploitation and implementation of alternative methods of infrastructure financing;

c. improvement and consolidation of debt management;

d. overall management and administrative efficiency;

e. economy, efficiency and effectiveness in the delivery of public services;

f. where appropriate and feasible, recovery of full costs of service from direct users, by economic efficiency pricing;

g. introduction and use of appropriate technology;

h. use of "market-friendly" approaches in the procurement of the factors of production, in the form of goods and services;

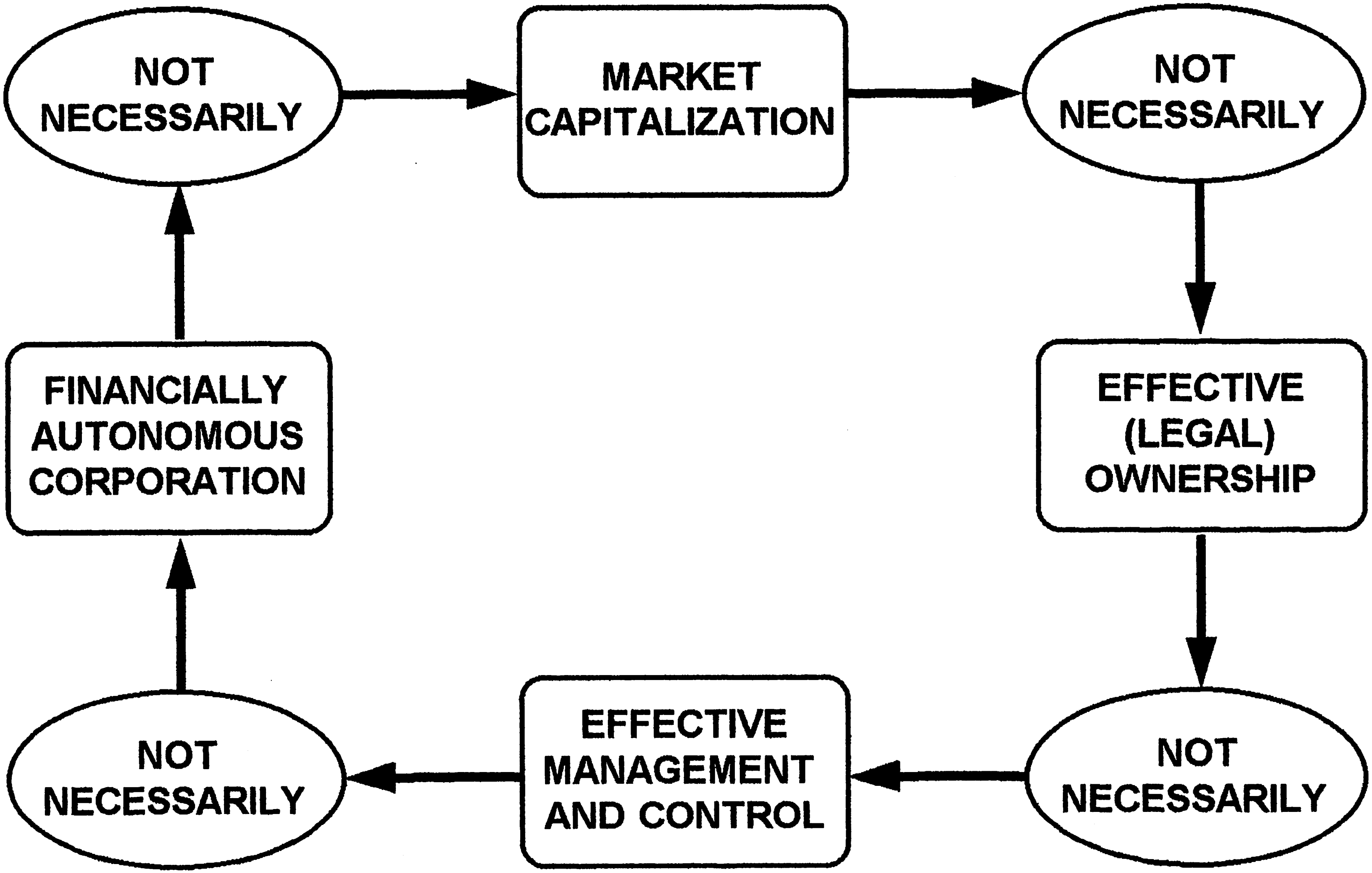
i. limitation of otherwise unconstrained demands upon the general revenues of the public budgets; and,

j. maximization of operational autonomy, consistent with optimal accountability for both stewardship of resources and performance of activities.

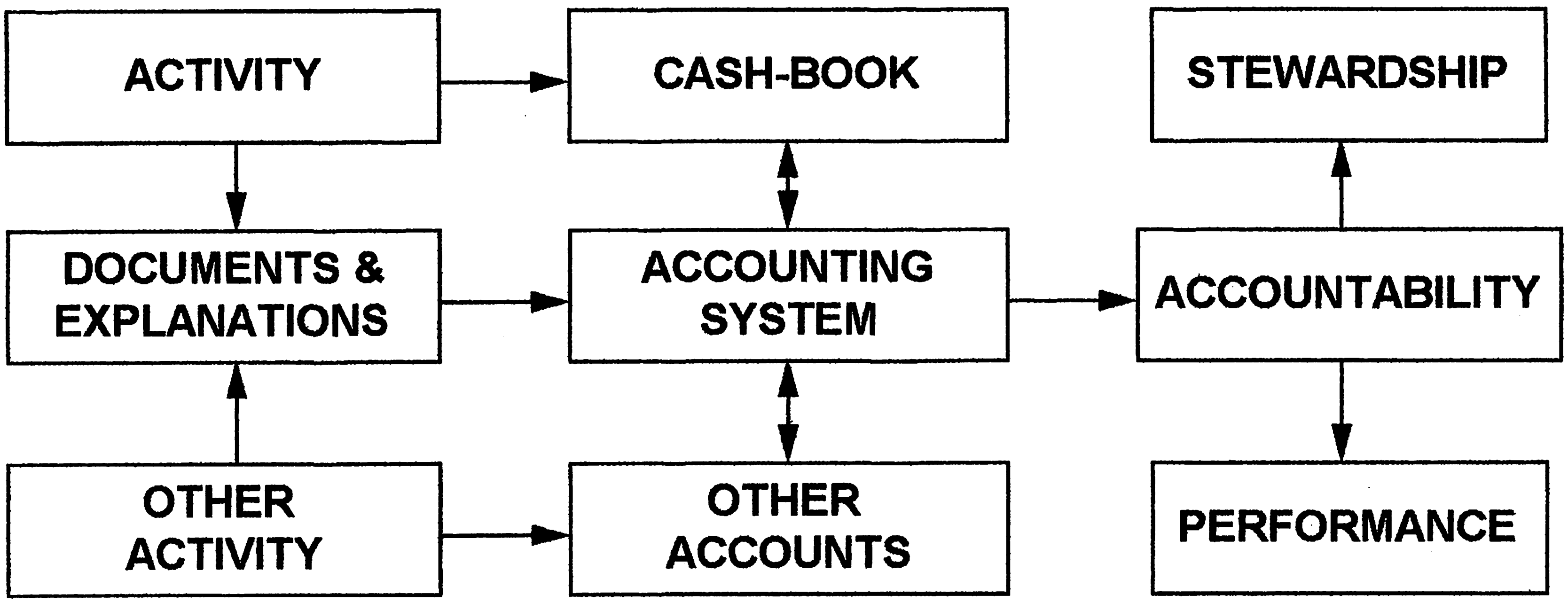
112. Finally, as much of the activity under the control of public entities is clearly concerned with government and public service delivery, it is essential that their activities be (and be seen to be) consistent with the prevailing political agenda.

ANNEX A

PRIVATIZATION CONCEPTS

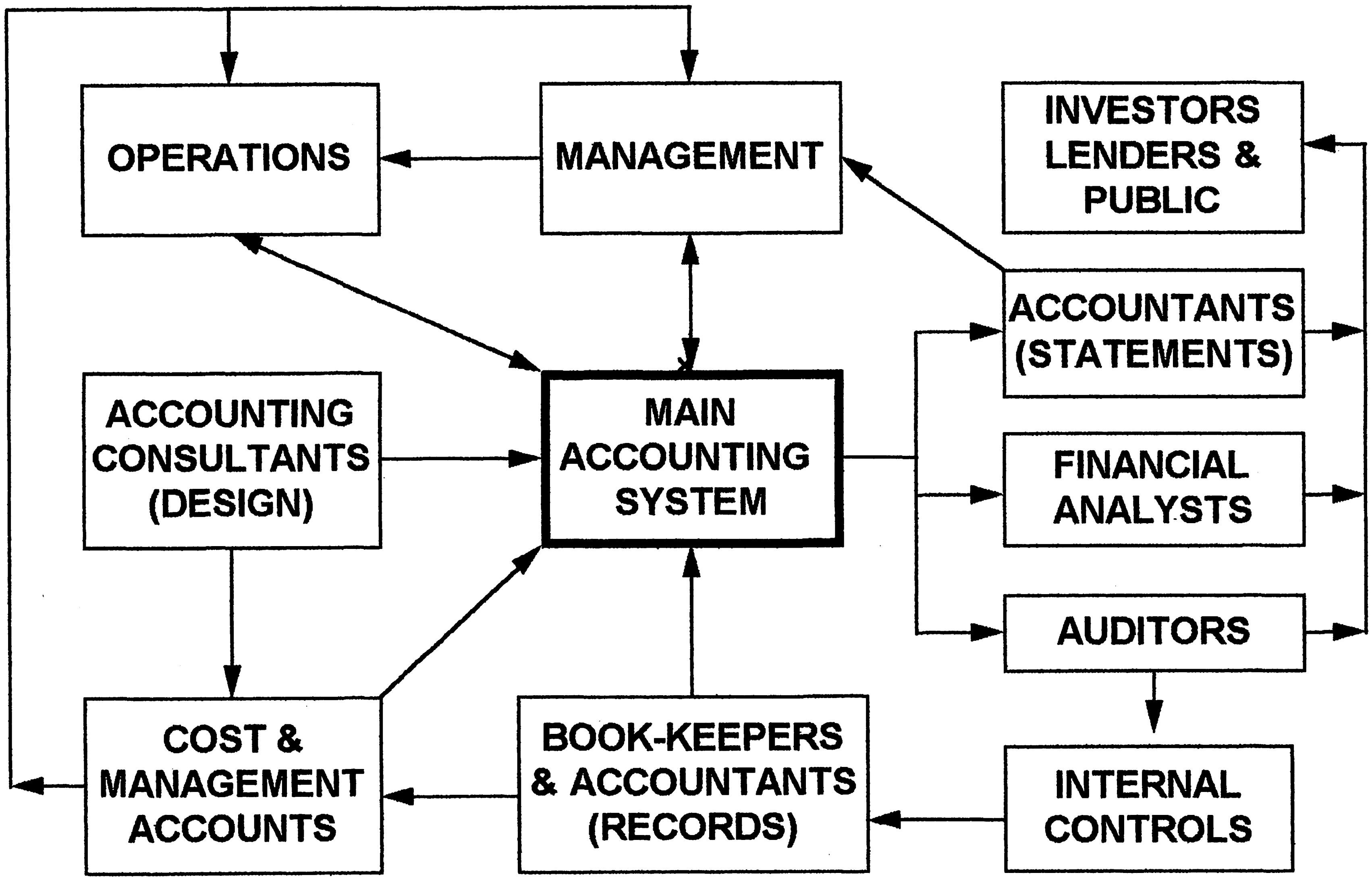


ACCOUNTING FLOWS



ANNEX C

ACCOUNTING ORGANIZATION



CONTRACTING OUT OF PUBLIC SERVICES

Conditions Likely to Facilitate Economic, Efficient and Effective Implementation

1. Credible and comprehensive accounting systems, which ensure that comparison of alternative in-house costs (including administrative overheads) with contracting-out (including regulatory costs) is meaningful, reliable and useful.

2. An economic overview, to mitigate against the potential for private business financial savings to merely become additional public costs (such as those for welfare payments to compensate for lost employee benefits or through economic externalities or inequities resulting from lower service standards).

3. Bidding and contract evaluation which ensures that selection based on price is also consistent with acceptable quality.

4. Fees paid by the government to cover all business costs of the contractor, including return on capital and reasonable profit.

5. Service not a natural, actual or near monopoly and therefore subject to meaningful competition and a potential for exit.

6. Service not potentially prone to crisis conditions, in the event of contractor or supervisory shortcomings, causing:

   a. breakdown of security, safety, law, order and government;
   b. conspicuous and immediate public dissatisfaction;
   c. disruption or distortion of public policy goals; and
   d. potential political threat to key elected officials.

7. Relatively swift, easy and inexpensive recovery in the event of contractor failure to deliver, including withdrawal from contracts and reinstatement of alternative delivery systems.

8. Relatively easy and inexpensive execution, administration and supervision of contracts, including cost accounting for this.

9. Willingness (or requirement) of private contractors to follow employment practices which are decent, fair and dignified.

10. Inability of contractor to conceal or obscure long-term costs, including those of depreciation and maintenance, which may not be obvious from accounting or management information systems nor from reasonable and customary physical observation.

11. Avoidance of fragmentation in the overall strategic delivery and management of public services, creating administrative or economic costs exceeding those saved by contracting out.

12. Resulting overall economic and social outcomes which are compatible with the prevailing political discourse.