Water finance: Preparing for the next critical juncture

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This paper looks at the role of public and private sector financing in providing water infrastructure and sanitation services in developing countries. The authors look at problems with the three T's approach advocated by the OECD – tariffs, taxes, and transfers – and argue that simply financing more water infrastructure and services – from public or private sources – will not solve the problem. They conclude that changing how the money is budgeted, targeted and executed is the proper place to start.

Keywords: public, private sector, financing, water infrastructure, sanitation services, developing countries

Water supply, sanitation, and irrigation infrastructure provide the critical water services that make economies prosper, and the costs of sector investments are low compared to the benefits they provide. By 2025, global water sector spending will be in the trillions.[1] By 2050, the pace of urbanization will be such that achieving universal access to water supply and sanitation will cost the developing world an additional 1% of GDP ($7.6 billion) every year compared to current needs.[2] The poorest of these countries, despite their greater need, will have the fewest resources to invest.

The 2008 global financial crisis has introduced a new dilemma. As GDP growth slows, so does funding for water services. Credit for developing countries has dried up[3] and current private participation in water is only about a third the size of development

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assistance to the sector. Within that slice, international and domestic investors are working with an increasingly narrow list of large, urban areas in middle income countries.

By and large, low income countries are considered too risky for investment. But with water demand outpacing supply in several large cities, they could become the next growth market for international investors. In order to make private money work to their advantage, these countries will need a sturdy public sector that can promote efficiency and equity in water services and that can ensure a stable enable environment, including institutional, legal, and regulatory structures.

It is estimated that more than 75 percent of all sector funding is provided through public sources, coined by the OECD as the 3 "T"s, or tariffs, taxes, and transfers. While highly desirable for funding and maintaining infrastructure (because they don't have to be repaid), each T has a set of drawbacks that make it less optimal (in many cases) than private sector funding.

Tariffs are collected directly from households in exchange for water services. If set too low, they risk putting service providers out of business and providing incentives for people to over consume. If set too high, they are not equitable and leave customers dissatisfied.

Tax revenues are provided annually from national or sub-national governments to local service providers. As tax revenues change, so do water budgets, leaving service providers with only short-term cash that does not promote long-term investment or incentives to improve performance. A recent study by WaterAid shows many countries in Africa reduced their budget allocations to water between 2008 and 2010.[4] Furthermore, most developing countries run their budgets on yearly cycles, creating an uncertain environment on future tax revenue streams that will be allocated to water. This is a perverse incentive for operators to enter into long term sector planning.

Transfers from donors are well-intentioned but less effective by the time they reach the local service provider. They are as subject to the same volatility as taxes and slower to deliver on promises: sector disbursements average only 70% of commitments. Transfers are also rarely aligned with local capacity to spend the resources. In a 2011 GLAAS survey of 38 countries, a meager 18 percent of participating countries disbursed more than 75 percent of donor capital commitments to sanitation.[5] This is also exacerbated by the (sometimes) discrepancies between Donor and country/sector priorities.

Each of these three "T's" has its way of crystallizing the status quo, whereby infrastructure is fixed in the short term without incentivizing long-term efficiency improvements or long-term thinking on

investment. This arrangement has left poor countries at a critical juncture. Once the world economy starts accelerating again, both private and public funds will rush into the sector. Unless serious reforms are in place, more dollars will go to waste and the status quo could become solidified to the extent that it is irreversible.

Countries need to be ready to make the best use of all their resources by improving water's public sector framework.[6] First, to protect the public's interest, they need to heed lessons from the history of privatization in water. This includes sound governance structures, enforced regulations, and separation of powers among institutions. Whether the private sector is brought in to improve operations; provide technical assistance; invest in, manage, or own the water infrastructure is irrelevant. The key is having a public sector that is willing to counter-regulate at the same speed: share risk, protect water consumers, and maintain control over performance and delivery of results. Second, governments need to drive service providers toward financial sustainability through two means: services that recover most, if not all, of their own costs, and more efficient public spending.

In many developing countries, recovering operational costs will require cutting expenses (through efficiency improvements, reductions in unaccounted for water and the like) and increasing revenues (higher tariffs and better collection rates). Four years of such efficiency improvements helped Uganda's National Water and Sanitation Corporation double its revenues. Reforms were realized through a private sector management structure whereby staff were paid to reach performance targets.

The other side of financial sustainability – government spending – can be improved by more transparent budgeting, long-term investment planning (that integrates the melting pot of funding sources), and hiring the right skill sets to manage the money. To do this requires a hard look at operating costs and the subsidies that pay for them – where they are going and how they are impacting the daily decisions of consumers and service providers.

While such reforms would make current spending more efficient, governments and donors can do much more to help address the financing gap. They have the power to make service providers more self-sufficient by allowing tariffs to reflect the real cost of services, or providing guarantees and risk pooling instruments that enable private borrowing. They can also remove the information asymmetries that block private finance from entering the water sector, whether that means inventorying assets, mapping out potential water markets, or showcasing creditworthy utilities. More transparency would reduce risks and entice

the private sector to court a new market of poor people that is 3 billion strong and growing. Lastly, they can work together to ensure that grants are allocated based on country and sector needs. This will ensure full ownership of the process.

The Philippines is implementing such game-changing reforms, taking a holistic approach that supports private participation while at the same time strengthening local government capacity to design and implement projects. The government, as financial broker, is pioneering a way to pool the risk (there are 6,000 small utilities) and leverage resources toward a more sustainable public-private partnership in water. But it is worth noting that these advances have been backed by top-level leadership, which is hard to come by in many developing countries.

Whenever it comes, the next influx of cash (and the mechanisms through which it is loaned) will set the pace for a new generation of water infrastructure. Poor countries should take this time to get their financial house in order by designing a sector investment plan like Indonesia's or undertaking a Public Expenditure Review, like Malawi. Such instruments will help public and private interests see the goal, understand the limitations, and budget and plan accordingly. They can also provide a framework under which donors and development institutions coordinate at the country level to provide longer budget cycles and more strategic support that aligns with their respective comparative advantages.

For most low income countries, simply financing more water infrastructure and services – from public or private sources – will not solve the problem. Changing how the money is budgeted, targeted and executed is the proper place to start.

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