

## Stimulating Development through Public Investment in Infrastructure: Scope and Issues

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### Background

“Infrastructure,” is not a term of art or science, and it can mean a number of services. However, considering those services commonly understood to comprise infrastructure – for example, power, telecommunications, water supply and sanitation, transport, irrigation, education, healthcare – a common thread seems to be that they underpin, or provide a backbone for, economic and social development. For example, factories are driven by power, transport and telecommunications underpin trade, and irrigation supports agriculture. Infrastructure is also critical to the alleviation of poverty. Bringing good roads or rail access to rural areas reduces the cost of transporting rural produce to market centres. Labour productivity of the poor will increase due to less time devoted to basic subsistence activities like fetching water or fuel wood. In similar vein, the provision of electricity and communication services leads to increased economic opportunities for the poor.

Another aspect common to “infrastructure” services as referred to above is that, until around the 1980s, most of these services (around the world) were provided mainly or exclusively by the public sector. This high level of public sector involvement has been linked variously to factors ranging from the monopoly nature of the service and the need to ensure equity in access and standards of quality, to more vague articulations of “national” or “public” interest. However, the performance of public sector infrastructure provision has, by and large, been somewhat below expectations. The lack of competition has marked a lack of innovation, efficiency and effectiveness in service delivery. Political interference has also impaired efficiency and effectiveness, being manifested in overstaffing, poor management and weak financial control.

Meanwhile, public sector infrastructure providers have been facing increasing financial stringency, flowing from weak government finances, while at the same time the achievement of economic growth has been demanding more and more investments in infrastructure. As a result, service provision has been unable to keep pace with demand. At the same time, large numbers of the poor, especially the rural poor, continue to be without basic infrastructure services. These several factors brought to the fore the imperative of rethinking the approaches taken to the financing, operating and managing of the delivery of infrastructure services.

A solution that became increasingly popular since the 1980s has been, to make way for greater private sector participation in infrastructure. It was based on the view that private participation in infrastructure can bring the needed additional resources to the sector, while having the potential of being more efficient than public sector activity in delivering less expensive, reliable infrastructure services to the whole community, including the poorest households. In order to realize these benefits, the government – central, regional or local, as applicable – has to establish a conducive legal and regulatory environment (for example, competition, property rights, contract and insolvency, etc.), ease risk perceptions that may hinder private investment and devise suitable mechanisms to ensure the achievement of social objectives (such as providing access to the poor).

### **Private-Public Partnership**

Private sector participation in infrastructure can be conceived of as ranging across a continuum of possible public/private relationships. It could range from service contract, where the public sector retains a significant degree of involvement, to concession/BOT (build-operate-transfer) type arrangements, where the private partner enjoys significant autonomy, to outright privatisation.

Which level of public/private mix is appropriate in a given infrastructure sector would be influenced by a number of factors, including the strength of the private sector, the administrative capacity of the government to regulate private suppliers, the performance of the public sector providers and the political consensus for private provision. Another key aspect influencing the form of private sector involvement is the amenability of the sector to competition. Unless private sector participation is accompanied by reforms to increase competition, the public monopoly would merely be replaced by a private one, with potential for monopoly rents to be extracted by the incumbent private operator. The introduction of competition can, on the other hand, bring benefits through increased efficiency and/or reduced prices. Developments in technology are already making more and more services open to competition, which had traditionally been thought of as natural monopolies. In other sectors, an element of competition can be built in by requiring the private sector to bid for a time-bound exclusive right (competition “for the market”), and by liberalizing the supply of substitute services (for example, road versus rail transport).

Even in the context of private sector service delivery, there would be a continuing need for government intervention to ensure that market failures are properly rectified. For example, the higher costs and lower revenues associated with servicing remote areas means that they would be unattractive to the private sector. Therefore, suitable incentive structures should be devised by the government to ensure that the poor, including rural

poor, are not shut out. Innovative approaches such as output-based aid have emerged in recent years, to better target the delivery of infrastructure services to these groups, under conditions of private sector infrastructure provision, through a more strategic targeting of government subsidies and a sharper focus on leveraging private finance.

The government would also have to exercise a regulatory role to ensure that service quality standards are adhered to by the private provider(s). Where there is competition in the sector and customers have access to information, this role could be quite limited. On the other hand, where the delivery arrangements tend towards a monopoly situation, the regulator would have to be strong. A robust regulatory framework structured around the principles of accountability, transparency, participation and consistency would not only safeguard the public/users, it would also go a long way towards attracting the needed private investment (especially foreign direct investment) to the sector.

The World Bank's Private Participation in Infrastructure (PPI) Project Database tracks infrastructure projects owned or managed by private companies in energy (electricity and natural gas transmission and distribution), telecommunications, transport, and water and sewerage. According to a review published of projects with private participation between 1990 and 2001, 132 low- and middle-income countries introduced private participation in infrastructure sectors, with 57 of them doing so in three or four sectors. During that period, the private sector had taken over the operating or construction risk, or both, for almost 2,500 infrastructure projects in developing countries, attracting investment commitments of more than US\$750 billion. The projects have ranged from management contracts (with or without investment commitments) to divestitures to build-operate-own (BOO) or build-operate-transfer (BOT) contracts for greenfield projects with merchant facilities. Telecommunications and electricity accounted for 72 per cent of the cumulative investment total.

### **Sri Lanka's Experience with PPPs – Far From Satisfactory**

In Sri Lanka, private participation in infrastructure was placed on centre stage with the privatization drive that was part of the second wave of economic reforms of 1989 to 1993. Major state-run infrastructure sectors such as telecommunications, public bus transport and gas were divested / given over to private management. This took place against a context of mounting budget deficits due to massive expenditure on defence, welfare, decentralisation and public sector pay hikes, when the government was finding it increasingly impossible to invest in necessary improvements to infrastructure. The privatisations also led to the creation of new sector regulators, such as the National Transport Commission and the Telecommunications Regulatory Commission.

From early 1993, the government looked for private sector participation in infrastructure development under BOT/BOO schemes. The Bureau of Infrastructure Investment was established in 1993 in order to function as the main focal point in government to facilitate BOO and BOT projects. In addition, a new company called the Private Sector Infrastructure Development Company was set up, to disburse funds on the promotion of private investment in the infrastructure sector. However, the response from the private sector was not satisfactory presumably due to the uncertain economic environment created by the North/East war at that time.

It may be noted however, that the liberalization process after 1989 gave relatively low priority to institutional structures, and to updating the regulatory frameworks to facilitate a liberalized economy. As a result, problems arose with the new regulators, with coordination within government and the legal support structure. These problems may have resulted in the failure to achieve the full potential of the privatisation/deregulation exercise. To address these regulatory issues, the Public Utilities Commission was formed in 2003 as a multi-sector regulatory body.

In 2004, a policy was enacted to making key state-owned enterprises (SOEs) which are of national interest more efficient and financially viable, while retaining them within State ownership and management. A Strategic Enterprise Management Agency (SEMA) was set up by a Presidential Directive, charged with implementing this policy. The key SOEs brought within its purview included the remaining state-run infrastructure giants, the loss-making Ceylon Electricity Board (CEB) and the Ceylon Petroleum Corporation (CPC). However, very little improvement in performance – in regard to financial losses -- was seen in them under the new framework.

Even today, the CPC and CEB are costing the state billions of rupees in budget transfers and it remains to be seen what innovative solution would be adopted to extricate them from their present perilous financial, managerial and operational difficulties, and provide an efficient level of service to the public.

There is little evidence today to indicate that the PPP model is actively used in infrastructure development, in particular, roads, water, railways, etc., although the model has been used to some degree in telecommunications, electricity, bus transport, etc. For rural electrification and water supply, irrigation, roads development once again there is heavy reliance of public investment. It may be stated here that the significant role of public investment depends on the stage of development of an economy. In countries where the private sector is in the early stages of development and where regulatory frameworks are weak, the public sector has a crucial role in developing and promoting the infrastructure. Although Sri Lanka now has become a lower middle income country with a per capita income level of US\$ 2,836, the country still seems to

be more comfortable in moving forward with an average 6% GDP public investment than relying on PPP for large infrastructure projects.

There is a noteworthy side in modern public investment, i.e., with the rapid growth of IT, it is now possible to improve the business environment by allocating more public funds for updating technology, computerization, etc. Even when economic reforms are not moving, public funds allocation to this area can contribute to the improvement of the 'doing business' environment. This we saw in Sri Lanka during the last 5 years where the 'doing business indicators' (DBI) improved -- it is now rank 81<sup>st</sup> out of 185 countries -- consequent to number of IT related modernization and improved connectivity.

However, while taking note of these new dimensions, it is imperative to take into account the limitations of public investment.

### **Stress on Public Exchequer**

Public investments should be such that it does not lead to large budget deficits. Normally, in government budgeting, there should be a surplus in the current account of the budget. This surplus could be supplemented by domestic borrowing or foreign borrowing or a combination of domestic and foreign borrowing to fund capital expenditure which basically means public investment.

Sri Lanka, for instance, saw large scale public investment, sometimes exceeding 10% GDP, during the time of the accelerated Mahaweli Development programme. With such large scale investment, there was overheating of the economy with large budget deficits. These deficits were funded by foreign concessional loans and large scale domestic borrowing. When bank borrowing forms the bulk of domestic borrowing, inflationary pressure builds up in the economy and becomes an issue for private investors.

### **Improving DBI and Crowding-In: Limitations**

Another factor that needs to be looked at is the rate of return of some of these public investment driven infrastructure projects. If returns do not come in the medium term, the expected results of 'crowding-in' the private sector, and smoothing the 'doing business' environment will not manifest in the economy.