REDUCING GLOBAL POVERTY:
ENCOURAGING PRIVATE INVESTMENT IN INFRASTRUCTURE

EXECUTIVE SUMMARY

Greater private-sector participation in building, financing, and operating infrastructure in the developing countries can promote economic growth and reduce global poverty. Private infrastructure projects, often known as "public-private partnerships," employ private-sector entities to supply physical infrastructure and services in such sectors as power, telecommunications, transportation, sanitation, and water in developing countries. Often donor agencies, such as USAID and the World Bank, support these arrangements through financing and technical assistance. Although private investment in developing country infrastructure is currently far below its 1997 peak, **the private sector has much to offer in both human and financial resources and should be part of the solution to meeting the vast infrastructure needs of developing countries.**

Types of Arrangements for Private Investment in Infrastructure: Contracts, Output-Based Aid, and Pooled Financing

Private infrastructure contracts spell out the public and private sectors' duties and responsibilities. Many projects have foundered because of misunderstandings, poorly specified contracts, or a lack of execution by one or the other or both of the contracting parties. Equally important to making projects successful, and often lacking, are the transparency of decision making to combat corruption and the legal and regulatory institutions that permit enforcement of contracts and the adjudication of disputes.

Private infrastructure projects have included innovative ideas in both finance and implementation. *Output-based aid* is a strategy whereby a public agency supports the financing of infrastructure projects through payments that include a subsidy component contingent on the private contractor's achievement of specified performance targets. This approach has great potential to significantly increase the amount of investment in critical infrastructure sectors in the developing world such as water, sanitation, power and transportation. *Pooled financing* is another strategy. It aims to overcome private-sector investors' concerns about the viability of individual projects by spreading risks over a broad portfolio of development investments.

These seemingly small innovations in contracting, service delivery, and finance, when taken together, can bring a sea change in the effectiveness of development aid. By emphasizing quantifiable goals, transparency, and greater accountability, they can also increase public confidence in and support for programs to eliminate global poverty.

The Need for Private Partners: Background and Trends in the Provision of Infrastructure

Despite decades of investment in the infrastructure of developing countries, the scale of unmet needs is overwhelming. The World Bank estimates that about 2 billion people lack an electrical connection, 1.1 billion people lack a safe water supply, and 2.4 billion people lack adequate sanitation. Until the early 1990s, infrastructure was usually provided and regulated by the public sector, and in most developing countries, it still is. The shift toward private sector involvement was motivated in part by inefficiencies in the public provision of services, including large losses due to mismanagement, graft, and corruption, and an increasingly apparent gap between growing national demands and tightening budgetary constraints. An ideological shift away from central planning and toward freer markets also played an important role.

Annual flows of public and private funds invested in infrastructure projects in developing countries rose from less than $13 billion in 1990 to more than $114 billion by 1997, but have been declining since. The East Asian financial crisis and the macroeconomic problems in Latin America are often cited as contributing to the decline. Another frequently cited cause is the failure of some high-profile, high-cost projects that have met popular resistance. Overconfidence in performance and underestimation of risks also may have led to many ill-considered projects. Ultimately, the primary, and continuing, cause of the inadequate level of private investment in infrastructure is the inability of many developing-country governments to take the necessary steps to maintain sound economic policies, improve governance, and eradicate corruption, and the failure of public-sector entities in the developing world to honor their commitments in the face of large increases in payment obligations that these entities either could not – or did not have the will to – honor.

Benefits of Private-Sector Infrastructure

About 95 percent of the 2900 private infrastructure partnership projects tracked by the World Bank are operational. World Bank studies suggest that these projects have improved services by adding customers, increasing quality, and lowering costs, including those associated with corruption. Some of the biggest gains from private infrastructure projects come from extending services to previously unserved populations. Efficiency improvements resulting from private participation show cost savings in the range of 10-30 percent. Examples of successful projects summarized in this report include Ecuador's water and sewage services, electrical connections to rural households in Mozambique, transportation in Chad, urban infrastructure development in India, and telecommunications services in Nigeria.

Roles and Responsibilities of the Public and Private Sectors

The initiative usually resides with the host government to decide whether its goals can be realized better through a private infrastructure project. Such projects can be especially complicated and tax the resources and abilities of host governments. The government must not only specify the scope of the project, performance targets, and the compensation scheme by which the private company will be paid, they must also assure the private investor of sound economic and regulatory policies, and of political stability rarely found in developing countries.

The private-sector provider's role is to help finance and plan the project, and ultimately, deliver the goods and services. Private-sector efficiency is more likely to be achieved with competition, especially during the bidding phase of a project, and a well-drawn contract. It is of the utmost importance that commercial risk for project construction and operation be transferred from the public to the private sector for a successful private infrastructure project.

In turn, private-sector entities providing infrastructure in the world's poorest countries will need to obtain stronger support than in the past from creditworthy governmental entities (including the World Bank and its constituent institutions and OECD governments) to assure that if the private-sector providers of services meet their obligations, the public-sector entities will honor their commitments to pay the amounts agreed and to carry out their other obligations.

Improving efficiency and ensuring that money is well spent are critical to a donor's mission. Donors see their roles as bringing together public and private partners, targeting funds to fill a specific financing gap, and helping to strike an appropriate assignment of commercial and political risks between the partnering parties. In order to enhance the prospects of success for private infrastructure projects, donors mitigate risks by providing an assortment of guarantees and insurance services, supply technical assistance to client governments, and assist these governments in developing an incentive contract to ensure the delivery of specified outputs and services.

Conclusions and Recommendations

The private sector has much to offer, in both human and financial resources, but private participation in infrastructure is not a panacea. Private infrastructure projects are not easy to implement. But the scale of needs is large and the private sector must be part of the solution to meeting those needs. To obtain the benefits of private-sector involvement, public administrators need to be able to create contracts that establish the right incentives; they need to set up well-functioning supporting institutions; and they need to transfer enough commercial risk and responsibility to the private sector. Transparency on the part of both public- and private-sector participants is a particularly important part of the process because it helps create public legitimacy and thwart corruption. And donor entities need to provide creditworthy supporting mechanisms to assure that if the private-sector partners meet their commitments to deliver essential services in the poorest countries, the payment commitments for these services will be met in the agreed-upon amounts.

In many developing countries, public support for private participation is low, in part because of price increases for services from newly built projects that are above levels previously charged by governmental providers, which often heavily subsidized users (as in the case of provision of power by state-owned entities in India). **Host-country governments and aid donors must do more to overcome public resistance by explaining the benefits of foreign investment in infrastructure. They must also do more to entice private-sector participation by becoming more effective and reliable "partners."** Profit-making firms need the incentive of profit to induce investment. Developing-country governments must increase efforts to establish and maintain sound and stable economic policies and to eliminate corruption**. Among the most important actions developing countries can take are:**

- **To be fully transparent about all aspects of private infrastructure projects;**
- **To establish sound and equitable pricing policies; and**
- **To devote sufficient talent and resources to the development of private infrastructure project contracts and regulation.**

The shared goal of raising incomes and reducing poverty in developing countries demands that public and private sector leaders work as partners to improve the quantity and quality of vital infrastructure projects.

Executive Summary of a Policy Update by the Committee for Economic Development (CED)
August 2006

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