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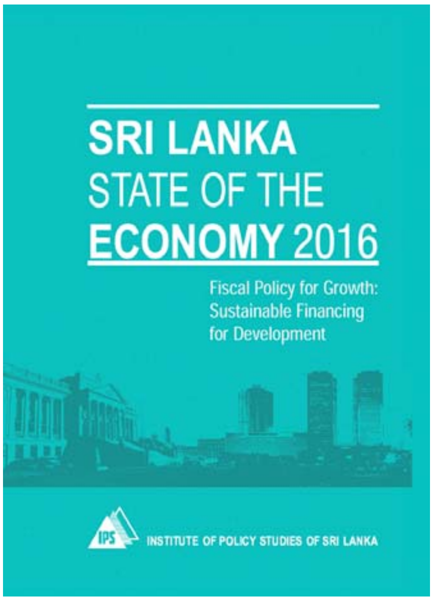
POLICY INSIGHTS

INSTITUTE OF POLICY STUDIES OF SRI LANKA

FINANCING URBANIZATION

From the IPS flagship publication 'Sri Lanka: State of the Economy 2016 Report'



With growing population and greater demand for urban lifestyles the existence of huge megapolises is becoming prominent around the world. The Sri Lankan government has planned to develop the entire Western region spanning Colombo, Kalutara, and Gampaha into a Megapolis by 2030 under the Western Region Megapolis Project (Megapolis Project).

This Policy Insight aims to analyze optional financing mechanisms available to meet the financial requirements of the Megapolis Project.

Despite the availability of detailed plans and information about the projects associated with the megapolis, there is a noticeable lack of focus on financing this massive initiative.

In this context, the rest of the paper provides some alternative methods of raising funds to finance this Project.

Generally, there are two different ways governments fund urbanization projects - their own revenue or external financing. Methods of own-revenue financing include user charges and local taxes. Methods of external financing include, borrowing from abroad, and public private partnerships (PPP) where a private company manages, builds or runs a part of a development project. Given the scale and cost of the Megapolis Project, the government is not able to support it all by itself, but must look towards the private sector and develop a PPP.

There are different types of PPPs; however all offer common benefits, which include risk-sharing by the public and private sector, and increased incentive for the efficient delivery of a project or service. Also, the selection process involved contributes towards making the projects sustainable.

In order to reap these benefits, a PPP must be supported by the government. This includes careful tariff setting and pricing, as well as an appropriate legal framework. The legal framework must ensure rigorous planning and risk assessment, transparent and competitive procedures, a strong system of monitoring, and flexibility.

Within the umbrella of PPPs, capital for financing a large scale development project can be raised in many ways.

Leveraging existing assets

One option is for Sri Lanka to leverage its existing assets, potentially through land based financing; this is where Sri Lanka either sells or leases land and uses the

"The viability of the entire Megapolis Project is uncertain due to three financing related issues - (i) absence of detailed plans for financing, (ii) the necessity to raise funds up front, and (iii) the budgeted cost of USD 40 billion far exceeding the budgetary allocations."

profits to pay for urban development initiatives; one advantage of land based financing is its ability to generate cash up front.

However, land based financing has the capacity to introduce significant fiscal risks, such as diverting proceeds for current expenditure and using land as collateral for debt. As such, it is important to introduce rules to assign and protect property rights; create institutions to calculate the value of land, and create a strong legal framework with a healthy judicial system to handle disputes and oversee the process.

Other ways to generate funds from existing assets include property taxes and levies. However, property taxes and levies are hard to collect and require a well-established, functioning property tax regime.

Paying for Infrastructure through Ancillary Services

In many infrastructure development projects, the developers/investors cannot recover the full cost of their investment on user fees alone. For such projects, one way to attract investors for PPPs is to offer rights to related ancillary services. For example, one of the identified Megapolis Projects includes the development of Multi-modal transport hubs. Some ancillary services concessions that can be offered include: restaurants, gas stations, parking lots, etc. Coupling basic infrastructure service with additional revenue generating opportunities can make funding possible with minimum burden on regular government budgets. Moreover, when infrastructure service is independent of fiscal processes, the government is better insulated from political influence.

UDA Debentures/ Municipality Bonds

Another method of financing is to issue sub-sovereign bonds, including municipal bonds, and bonds from the Urban Development Authority, (UDA) implicitly backed by the government. However, previous experience of UDA debentures highlighted poor fiscal management; which may hamper attracting additional funds through sub-sovereign instruments.

Project Bonds

Another option is to issue project bonds: standardized securities that finance stand-alone infrastructure projects. These bonds offer a higher risk of loss than a diversified portfolio of projects; however, literature notes that Project Bonds are a more viable option for large projects and when longer duration finance is needed.

Establish Government Creditworthiness

Attracting investors and funds boils down to the creditworthiness of the government. The best way to establish creditworthiness is by securing cash flows from user fees and taxes in the Western Region. Some key steps to improving creditworthiness include ensuring transparency in the Megapolis Project and applying for credit rating from international credit rating agencies.

The Megapolis Project is a colossal project estimated to cost over USD 40 billion, spanning over a period of 15 years with the aim to transform the entire Western Region into a megapolis. Given the fiscal situation of the economy and the magnitude of the proposed project, the government budget cannot finance the entire effort. However there are many alternative options for Sri Lanka to consider, including PPPs. Whatever combination of financing methods Sri Lanka chooses the Megapolis Project has to be rolled out cautiously to ensure that the expected growth is achieved.

This Policy Insight is based on the comprehensive chapter on "Financing Urbanization" in the 'Sri Lanka: State of the Economy 2016 Report' - the flagship publication of the Institute of Policy Studies of Sri Lanka (IPS). The complete report can be purchased from the publications section of the IPS, located at 100/20, Independence Avenue, Colombo 7. For more information, contact the Publications Unit on0112143107 /0112143100.

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