



# INCENTIVIZING ASIA'S URBAN FUTURE

Background Paper

CDIA High-level Urban Policy Roundtable

ADB, Manila, 14 November 2011



**CDIA**

Cities Development Initiative for Asia

This background paper on “Incentivizing Asia’s Urban Future” was prepared by Royston A. C. Brockman for the Cities Development Initiative for Asia High-level Urban Policy Roundtable, to be held at the Asian Development Bank (ADB) in Metro Manila, Philippines on 14 November 2011.

During the roundtable an eminent group of about 20 political leaders, urban specialists, and concerned civic leaders will deliberate on the role of Asian cities in the world economy and discuss what Asian cities should do in order to maintain and enhance their competitive edge, while ensuring that their development is inclusive and sustainable. This paper calls upon Asian countries to make urbanization (and urban infrastructure development in particular) a key instrument for enhancing growth, combating poverty, addressing climate change, and serving as a stabilizing factor in the regional and global economic system.

It is envisaged that the roundtable will collectively provide a message—in the form of the “Manila Declaration” on incentivizing Asia’s urban future—to ADB’s Urban Forum 2011 entitled “Financing Future Cities” on 15 - 17 November 2011.

## Table of Contents

<b>An Urban Asia by 2025 .....</b>	<b>1</b>
<b>The Big Issues Facing Asian Cities .....</b>	<b>2</b>
Making cities more competitive .....	3
Ensuring that cities are more inclusive .....	4
Enabling green cities .....	5
Freeing up cities, financially .....	6
Developing capacity for urban management .....	7
Major gaps need to be bridged—bringing it all home .....	8
<b>Incentives to Bridge the Gaps—The Carrots and the Sticks .....</b>	<b>10</b>
Bridging the policy and regulatory gap—long-term planning .....	10
Bridging the institutional capacity gap—coordination and capacity development .....	10
Bridging the jobs and opportunity gaps—towards more competitive and inclusive cities .....	12
Bridging the sustainability, infrastructure, and finance gaps—local government finance .....	12
Bridging the sustainability, infrastructure, and finance gaps—incentivizing private sector finance.....	15
<b>Moving Forward—What Governments and the International Community Can Do .....</b>	<b>18</b>



## An Urban Asia by 2025

Asia's cities have helped prevent the complete collapse of the world's economic system following the global financial crisis in 2008. The driving force behind this has been the growth of Asia's urban areas. But if Asia is to continue to lead global economic growth, then its cities need to be up to the task. Unfortunately, many are not. Their existing infrastructure is under stress, and not enough is being built. Spatial growth is haphazard, and manifest in urban sprawl on the periphery of many cities.

Most new entrants to urban life reside in informal settlements or shantytowns. Poverty levels remain stubbornly high in cities, although lower than in rural areas. Governments cannot afford to ignore the urban sector; they do so at their own peril. Investment in urban infrastructure, slum upgrading, job creation, and capacity development is needed on a massive scale to ensure more liveable cities.

People are leaving the countryside in Asia in large numbers—on a scale that has never been seen before. Asia's urban population is likely to reach 3.5 billion by 2050 (Figure 1).<sup>1</sup> Between 2010 and 2050, the urban population of Asia will almost double, adding as many people to urban areas in one generation as in all of history—an average of almost 41 million every year.

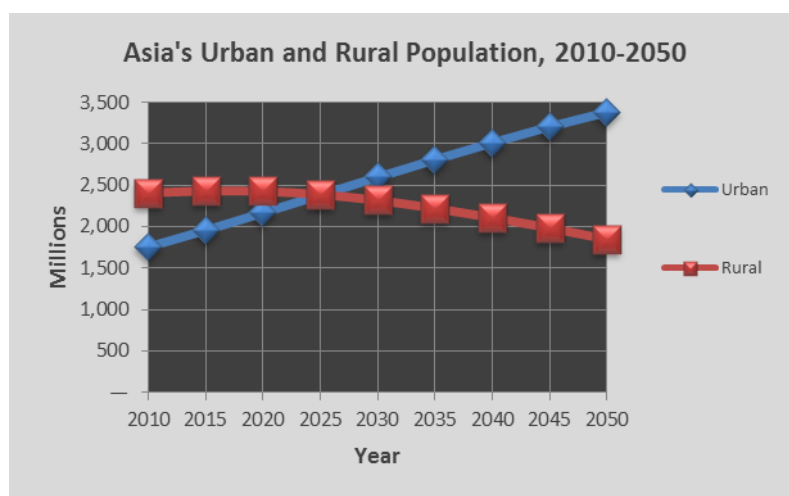
The population of Asia's countryside will stop growing around 2019, and by 2050 will have fallen by 0.6 billion, mainly because of migration to the cities. India's rural population, one of the last to stop growing, will peak in 2025 at 908 million and will fall to 739 million by 2050. In 2010, 40% of Asia's population lived in urban areas. By the end of 2025, 50% of Asia will be urban, by 2050, about 65%. At the end of the century almost all of Asia will live in cities.

*Asia's urban areas are driving economic growth, but many of its cities are not up to the task*

*Massive investment is needed to ensure more liveable cities*

*By 2050, 65% of Asia's population will be urban*

Figure 1: Asia's Urban and Rural Population, 2010-2050



Over the next 15 years, the composition of the planet's top 600 cities according to gross domestic product will change as the center of gravity of the urban world moves to Asia. By 2050, it is expected that 136 new cities will enter the top 600, with about 100 of these from the People's Republic of China (PRC) alone.<sup>2</sup> Increasingly, businesses will be asking which cities offer the best prospects. Understanding the changing urban landscape is crucial for the sound development of cities.

*The center of gravity of the urban world is moving to Asia*

<sup>1</sup> World Urbanization Prospects. The 2009 Revision. United Nations Department of Economic and Social Affairs. Population Division. 2011.

<sup>2</sup> Urban World: Mapping the Economic Power of Cities. McKinsey Global Institute. March 2011.

The fastest growing urban settlements are secondary cities, but in practice they are more likely to be those within mega and other city regions/clusters, rather than stand-alone medium-sized cities. Young populations, a major feature of Asian cities, now and in the future, will fuel growth in the long term.

In 2009, the World Bank concluded that the most effective route to poverty reduction and economic growth is to encourage the highest possible urban population density and the growth of the largest cities—as long as they are the focus of intensive investment and infrastructure development. However, in many places, official attitudes and policies continue to lag far behind this broader understanding, and many still see a need to restrict rural–urban migration. Economic policies that actively discourage urban investment are being pursued in attempts to prevent more people from arriving in places where the opportunities are greatest.

Many Asian governments are aware that current urban policies are not working. Many have laudable objectives aimed at tackling urban poverty, improving housing, alleviating traffic congestion, mitigating climate change, and so on. But too little effective action is taken, and the problems remain. A paradigm shift is needed—one that moves in a new direction and adopts policies and incentives that encourage more inclusive wealth creation in our cities.

**What should the new paradigm be? What can we learn from the best cities in the world? Why have they succeeded while others have failed?**

*Encouraging the growth of the largest cities is the best route to poverty reduction*

*Current urban policy needs to change*

## The Big Issues Facing Asian Cities

The Economist Intelligence Unit's Global Liveability Survey 2011 rates Asia's cities low. Out of 140, Hong Kong was ranked 31st, Singapore came in 51st, and the PRC's megacities of Beijing and Shanghai were 72nd and 79th, respectively, while India's commercial hub of Mumbai was 116th, just above Jakarta at 119th. The worst places to live were Port Moresby in Papua New Guinea, Bangladesh's Dhaka, and Zimbabwe's Harare (see Table). The common elements of the top ranking cities —Melbourne, Vienna, and Vancouver— are guaranteed safety and stability; clean environment; and world class health care, culture, education, and infrastructure services.

*Asia's cities do poorly on world rankings of liveable cities*

Global Liveability Survey, 2011 – Top and Bottom Ten Cities. Overall Rating					
Top 10			Bottom 10		
1	Melbourne	97.5	131	Abidjan	45.9
2	Vienna	97.4	132	Tehran	45.8
3	Vancouver	97.3	133	Douala	44.0
4	Toronto	97.2	134	Karachi	40.9
5	Calgary	96.6	135	Tripoli	40.4
6	Sydney	96.1	136	Algiers	40.2
7	Helsinki	96.0	137	Laos	39.0
8	Perth	95.9	138	Port Moresby	38.9
9	Adelaide	95.9	139	Dhaka	38.7
10	Auckland	95.7	140	Harare	38.2



The ranking assesses living conditions in 140 cities. A rating of relative comfort for 30 indicators is assigned across five categories: stability; health care; culture and environment; education; and infrastructure. The survey gives an overall rating of 0–100, where 1 is intolerable and 100 is ideal.

Source: Economist Intelligence Unit. 2011.

The task in Asia is to build liveable cities—those that are competitive, inclusive, and green. To make cities more liveable, governments need to ensure a high quality environment, facilitate the creation of appropriately skilled jobs, and engage in more inclusive development. They need to use their resources to encourage the provision of world class infrastructure—physical and social—and provide opportunities for the upward mobility of the poor.

*Hence we must build more competitive, inclusive, and green cities*

**What incentives are needed to provide competitive, inclusive, and green cities—the basic elements of liveable cities?**

## **Making cities more competitive**

Economic performance is the combination of the capacity for wealth creation, the business environment, and the strength of research and development activities. The ability of a city to increase the incomes and productivity of its citizens depends on these three factors.<sup>3</sup> Migration of people to wealthier cities in search of higher incomes drives growth. Thriving urban economies sustain rural areas. Migrants, living mostly in informal settlements—, the only affordable solution for many— send money to relatives, who often remain in their villages for a generation, and these remittances encourage development. Mini construction booms in rural areas often follow urban migration, and numerous small enterprises spring up. These backward linkages will continue and will remain a feature of urban life for some time to come.

### **But what really makes a competitive city?**

Many common factors contribute to making cities competitive. These include high-quality infrastructure, good communications and public services, innovation and entrepreneurship, access to natural resources and skills, proximity to markets, ample social capital, and good quality of life. Not all cities have these. Improved competitiveness comes from pursuing a continuous process of and commitment to learning and adjusting to change, and responding to the outcomes of actions taken by competitors (Box 1).

Six building blocks determine competitiveness:

- a strong enabling environment—governance structures and organizational arrangements that provide a clear and transparent set of rules for business, and an appropriate regulatory environment for utilities and urban services;
- excellent business support— efficient flow of information, openness to business, and new ideas, transparent taxation regime, realistic costs of doing business, and the awareness and use of new technology; a highly regulated or controlled market inhibits the business environment;
- presence of endowed resources—both natural resources and the built environment;
- a good supply of diverse and developed human capital—alignment of skills and production bases, strong and effective local leadership, research and development capacity, and adequate social capital;
- presence of good quality strategic infrastructure that supports key industry sectors—telecommunications, transport and logistics, information and research facilities, and well-run public utilities; and
- catalysts that stimulate growth—entrepreneurship, management services, communities, and innovative incentives.

In summary, competitive cities require good infrastructure and logistics that serve the economic base of the city, an appropriate and business-friendly environment, a skilled and disciplined work force, and finance to make it all happen. People living in more competitive cities have better access to services such as education, health care, and security; more infrastructure—electricity, water, gas, sewerage, telecommunications, drainage and flood control, roads, and public transport; and responsive banking services. Competitive cities have efficient energy consumption, proper waste management, and strategic urban planning. And they are inclusive.

*Cities are competitive because of quality infrastructure, good communications and public services, innovation and entrepreneurship, access to natural resources and skills, proximity to markets, ample social capital, and good quality of life*

*Competitive cities need to have good infrastructure and logistics, be more business friendly, have appropriately skilled labor, and be able to raise finance to make it all happen*

<sup>3</sup> Urban World: Mapping the Economic Power of Cities. McKinsey Global Institute. March 2011. India's Urban Awakening: Building Inclusive Cities, Sustaining Economic Growth. McKinsey Global Institute. April 2010.

### Box 1: Building Competitive Cities—Greater Golden Horseshoe, Ontario, Canada

The Greater Golden Horseshoe, an area that rings western Lake Ontario with Toronto at its center, is Ontario’s fastest growing region. Its population is expected to be 11.5 million by 2031. Development has taken place in a haphazard manner, resulting in urban sprawl and gridlock. 2011 marks the 5th anniversary of the Growth Plan for the Greater Golden Horseshoe—the 25-year blueprint for managing urban growth. The plan guides decisions on how land is developed, resources are managed, and public money is invested. It creates an enabling environment for:

- revitalizing downtowns;
- creating complete communities—more options for living, working, learning, shopping, and playing;
- curbing sprawl by protecting farmland and green spaces; and
- increasing transportation choices to reduce gridlock.
- The plan directs population and employment growth to existing built-up areas to make better use of infrastructure and limit urban sprawl. It targets
  - building compact, vibrant, and complete communities;
  - planning and managing growth to support a competitive economy;
  - protecting, conserving, and enhancing natural resources—land, air, and water;
  - optimizing existing and new infrastructure to support growth in a more compact, efficient form;
  - providing approaches to managing growth that recognize the diversity of communities; and
  - promoting collaboration among sectors—government, private, and nonprofit—and residents to achieve the vision.



Source: Province of Ontario, Ministry of Infrastructure, Places to Grow website: [www.placestogrow.ca](http://www.placestogrow.ca)

### Ensuring that cities are more inclusive

#### What are the main impediments to making cities more inclusive?

Most cities suffer from conflicts over the distribution of land, resources, services, and opportunities, and these often engender disadvantaged areas and communities. Many cities have large “arrival areas”—informal settlements that are viewed with dismay and often seen as a counter to the city’s wealth. But these are the very areas that will determine the future of a city. Most residents of informal settlements lack appropriate land tenure, and without security people will not invest in more than basic needs. Most such areas have poor services—onsite and social infrastructure is bad or nonexistent.

Another impediment is the lack of connectivity to the city. Physical infrastructure and utility services, social services, and public transport are lacking, while business linkages are poor. Improvements in connectivity and better local infrastructure and services are needed. Individually, such improvements cost very little, but taken on a city-wide scale, the investment requirements are huge. The financing gap, though, is not all—many governments do not have the political will to improve these areas.

City administrations often fail to recognize that the residents of today’s poor areas are tomorrow’s middle class. But intervention is required now to enable the poor to climb the ladder of upward mobility. Simple actions such as formalizing land tenure—preferably through the award of land titles—upgrading services, and improving connectivity can have a catalytic effect (Box 2). Migration to middle-income housing areas becomes a reality, affordable through the sale of property rights in former informal settlements. This vacates space for new arrivals from the countryside and refuels the cycle. Such upward mobility dramatically increases the size of the middle class and the overall purchasing power of a city. By 2025, emerging markets will have more higher-end, middle-income households than developed ones, and by 2050, the purchasing power of Asia’s middle class is likely to exceed that of the western world.

*Asian cities have large “arrival areas” that are the initial destination of migrants from rural areas*

*These are the areas that determine a city’s future*

*Today’s poor are tomorrow’s middle class*

### Box 2: Incentives for Slum Upgrading—Thailand’s Baan Mankong Collective Housing Program

Inclusive urban development requires that residents of informal settlements become full participants in the economy and social life of a city. This means secure land tenure, proper physical and social infrastructure, space for businesses, and improved connections to the city. One such program supporting this transformation is the Baan Mankong Program—“Secure Housing” in Thai, which was launched in 2003 by the Community Organizations Development Institute with government funding.

- The program resolves housing and land insecurity of slum dwellers, city-wide.
- Its process involves slum surveys, community plans and designs, infrastructure improvements, and credit.
- Government funds are channeled, as infrastructure subsidies and soft housing and land purchase loans directly to poor communities, who plan and carry out improvements. Communities manage budgets.
- The program puts slum communities at the center.
- Community organizations and local authorities are the key driving forces.
- At the end of 2010, the program had been implemented in more than 270 towns and cities, benefiting about 92,000 families within 1,600 communities.



Source: [www.codi.or.th](http://www.codi.or.th). September 2011.

### Enabling green cities

Cities are consumers of resources and generators of waste, which often leads to land, air, and water pollution. All are in competition with nature for the scarce resources of land and its produce. Climate change, too, is posing massive threats to cities, especially those in coastal and low-lying areas—which happen to be where most cities are found. And many cities are now subject to increasing flooding, exacerbated by poorly maintained and inadequate drainage systems. Because of pollution, many city residents have turned their backs on their waterways. Rather than seeing them as places of recreation and beauty, they become stagnant and unwanted parts of cities. But cleaning up pollution and mitigating climate change require money—a lot of it. Both are in conflict for resources, which often places climate change adaptation and mitigation in competition with programs to reduce pollution.

It is essential that Asian cities become more efficient and less energy intensive. New buildings, especially those of the public sector, should become more compliant with the Leadership in Energy and Environmental Design or similar certification. More open space and greenery are needed. Land use distribution needs to be more rational, and better related to interlinked urban transport systems. More compact and public transport-friendly cities are required for which there are cost-effective solutions—bus rapid transit is far cheaper than a metro or light rail system, and they can have similar capacities (Box 3).

*Cities generate waste that contributes to land, air, and water pollution*

*Climate change poses a massive threat to cities in low-lying or coastal areas*

### Box 3: Retrofitting Urban Public Transport— Guangzhou Bus Rapid Transit

The city of Guangzhou in the PRC won the 2011 Sustainable Transport Award for its bus rapid transit system. The award is given to a city that has made the most progress in increasing mobility and reducing transport-related greenhouse gases and air pollution emissions while improving safety for cyclists and pedestrians. Guangzhou opened its first bus rapid transit corridor in 2010 to reduce congestion on one of the city’s busiest roads.

- The first line comprised 23 kilometers of segregated bus lanes, 26 stations, and 40 routes.
- By the end of 2010, it had an average of 805,000 passenger trips daily with a peak passenger flow of 27,400 passengers per hour per direction—second only to the system in Bogota, Colombia.
- Buses of seven companies come in and out of the system, reducing the need for passengers to transfer.
- Estimates are that the system has reduced carbon dioxide emissions by 86,000 tons annually.

Source: *Institute for Transportation and Development Policy*.



## ***Freeing up cities, financially***

There is an unmet demand for jobs, houses, and services in most cities, and reducing these gaps requires investment on a massive scale. Failing to do this will impose significant costs on cities in terms of lower productivity and growth. City governments that are able to raise or leverage finance to provide more efficient services are better able to compete. But local governments need to be in good financial shape to do this.

The scale and security of public finances and how well they are managed affect virtually every aspect of city development. Key factors are the extent to which cities are able to utilize local tax revenues, and the extent to which this revenue goes to and is controlled by the central government. Underinvestment through underspending is common and exacerbates the problem. But local funding limits will remain a challenge that cities will have to face.

Intergovernmental fiscal relations need improvement. Too often they are based on physical criteria such as area, population, or the classification of the city. Funds are released regardless of performance, and many local governments become too dependent on them. Central transfers can act as a disincentive to improving local revenues. Mechanisms need to be reoriented towards the accomplishment of clearly defined objectives that not only reward performance but also positively assist poorer regions and cities to become less dependent.

### ***Local governments also need to put their own houses in order. How can they do this?***

Taxes as a source of local government revenue vary widely. There is significant untapped potential from almost all local government own-source revenues. Land and property taxes and charges, utility tariffs, turnover taxes, and vehicle taxes can be buoyant and inflation proofed if properly charged and collected. But the coverage is low, and the base in most cities needs to be expanded significantly. Collection rates, too, are low, and significant improvements in revenues can be made through better enforcement, and by simply collecting what is due.

The share of local government revenue that a city derives from public debt also varies widely and often is not seen as a means of raising resources. In some countries, national regulations restrict borrowing, while in others the poor financial condition of local governments prevents access—impacting their creditworthiness. Direct loans are the most frequent mode of borrowing, since the municipal bond markets in much of Asia remain weak.

However, more resources are required to meet the demand for new infrastructure than are available from central transfers, local government own-source revenues, and borrowing put together. Turning to the private sector is a major initiative that, despite the rhetoric, has not been embraced universally. Public-private partnerships (PPPs) and community financing both offer untapped opportunities to expand resources (Box 4).

For example, the ownership of private vehicles is increasing rapidly, and the challenge is to find innovative ways of funding new infrastructure such as expressways and inner city roads that reduce the demands on the public purse. PPPs are a realistic option. Affordable housing is more than providing dwellings—it also involves constructing infrastructure and delivering services. But local communities and the private sector can provide much more. Health care costs, which will increase as populations age, will need to be funded. And cities require skilled workers, so increased higher education and technical and vocational skills will be needed. All these offer significant opportunities for the private sector, given appropriate incentives.

***Finance is needed to satisfy demands***

***We need to rethink how intergovernmental fiscal relations can be improved***

***There is a vast, untapped potential to increase local resources***

***We must also turn to the private sector.***

***But finance is not all***

#### Box 4: Yerevan—A New Local Government

Yerevan is an example of a city that has gained autonomy, unified its governance, and engaged the private sector in its water supply utility.

- In 1995, the Armenian Constitution initiated a system of local government. Ten marzes—regional bodies within the national government—including Yerevan, 48 urban local governments, and 866 rural administrations were established.
- Constitutional amendments strengthened local autonomy, and Yerevan became a municipality in 2009 that combined its 12 districts, each of which had local government status, into one city government with an elected council and mayor.
- In 1998, the government turned to the private sector to help its ailing water utility, Yerevan Water and Sewerage Company.
- A 4-year management contract was enacted to address the problems of nonrevenue water and low tariff collection. It was later extended to 5 years, and in 2003 a 10-year lease contract was entered into.
- Capital investments followed that would not have been provided by the public company. Institutional capacity and service delivery subsequently improved.



Enhanced local autonomy has meant greater accountability, and the unified city government has better coordinated planning and the provision of services. Private sector participation in Yerevan Water has improved coverage, provided 24/7 supply in most areas, and reduced the level of nonrevenue water throughout the capital.

Source: *Managing Urban Armenia. A Strategic Urban Assessment.* ADB. Manila. October 2011.

### Developing capacity for urban management

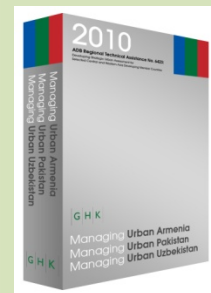
If Asia's cities are to improve, they need to build better systems for their institutions and to enhance the skills and capacities of their staffs. As cities grow, they must take on more diverse, difficult, and complex tasks. Competencies that are essential for managing cities fall into three groups: planning and policy, program and project formulation and structuring, and the management of service delivery (Box 5).

*Capacity is lacking everywhere in the core competencies of urban management*

#### Box 5: Core Competencies of Urban Management

Three core competencies of urban management are:

- **Planning and policy**—vision setting, policy formulation, regulatory environment/framework, strategic planning, and local/action area planning
- **Program formulation and project identification and structuring**—partnerships, liaison arrangements for cross-border/sector coordination, program/project formulation, resource mobilization, funds, organization and staffing, liaison with communities/private interests and participation, land and other inputs
- **Management of service delivery**—finance, development/construction, operation and maintenance, regulatory environment, organizational development and human resource management, and monitoring and evaluation



Source: *Managing Asian Cities.* Asian Development Bank. 2008.

Capacity is notoriously weak in local and regional governments, in national government infrastructure agencies, in much of civil society, and in the regulatory bodies. Low salaries as well as overstaffed and inefficient agencies characterize much of the public sector. Most local governments, except those in some of the largest cities, lack capacity in the core competencies of urban management: many are underskilled for the tasks of modern city governance. Strengthening these competencies is necessary. Emphasis should be on integrating capacity development within existing social, economic, and political frameworks (Box 6).

Capacity development has changed over the past 40 years from the 1960s model of setting up externally funded institutions to the strengthening of agencies in combination with overseas training. Project-related training has been a feature of most internationally funded programs, and, although there has been a recent shift towards the development of knowledge networks and results-based capacity development, little systemic change has taken place within urban institutions over this period.

Experience tends to show that tailor-made training courses rather than those provided by institutions are the most appropriate. The consensus now is that capacity development needs to change from externally and supply-driven approaches to become more demand responsive. But performance to date is disappointing. Many feel that local governments are no better now than they were 40 years ago, despite the considerable amount of resources made available for capacity development.

*Despite the huge investment in capacity development, many local governments are no better now than they were 40 years ago*

### Box 6: Borrowing for Capacity Development—Lessons from South Africa

The Municipal Financial Management Project, financed by the World Bank under a \$15 million technical assistance loan to the Republic of South Africa, was approved in 2002. It demonstrates a new approach and the willingness to borrow funds to enact improvements in local government financial management capacity. Funds were used to hire international and local consultants and specialists, companies, and existing education and training institutions. Project management was undertaken by the Development Bank of Southern Africa, through a memorandum of understanding with the National Treasury. It supported

- installation of new budgeting and financial management systems in 41 municipalities;
- design and implementation of a municipal sector financial monitoring system, municipal budgets and financial statements, and intergovernmental transfers; and
- municipal finance policy reforms, including
  - incentives to encourage municipalities to access finance through private markets, and implementation of the policy framework for municipal borrowing;
  - refocusing intergovernmental grants to enable municipalities to improve their creditworthiness;
  - reforming policies on the regulation of basic service provision; and
  - linking local government development plans and multiyear budgets within a broader strategy of building municipal capacity.

The project strengthened central and local government capacities in planning, budgeting, and implementation of best practices in financial management. A number of skills gaps that needed to be addressed through specialized training initiatives were financed. Skills transfer was a key part of the project and involved placing long-term senior advisors in local and national governments, and hiring key specialists.

The World Bank, in collaboration with bilateral agencies, leveraged \$4.9 million for local government capacity development.

Source: *Implementation Completion and Results Report on a Loan in the amount of US\$15.0 Million to the Republic of South Africa for a Municipal Financial Management Technical Assistance Project. The World Bank. December, 2008.*



### Major gaps need to be bridged—bringing it all home

Many of the problems facing Asian city governments stem from substantial gaps and deficits in policy and regulation, institutions and capacity, jobs, opportunities, sustainability, infrastructure, and finance. Only by reducing if not eliminating these gaps entirely will cities achieve their full potential.

**Policy and regulatory gap.** Outmoded policies and inappropriate projects are commonplace. Too often policies have not been updated to reflect changing circumstances and new thinking. Too many projects are approved on political rather than technical or financial grounds. There is a lack of freedom of information, and people remain ill informed about what goes on within public agencies. Communities are not involved in project selection, and regulatory environments are poor and seldom independent.

*All these macro problems stem from substantial gaps or deficits:*

*Outmoded policies and inappropriate projects*

**Institutional capacity gap.** Improved capacity has lagged behind the growth of urban populations and technological developments within the sector. Institutional structures to manage urban development are lacking—especially in rapidly growing cities that are fast encompassing neighboring towns and villages outside their jurisdiction. This has led to problems concerning investment decision-making and the enforcement of regulations. It leads to tensions between mayors and governors, and, too often, even neighboring local governments do not cooperate effectively. Weak coordination is a feature of most city-regions. Systems within local governments are outdated and unsuitable for modern urban management. There is a severe knowledge deficit almost everywhere, and deficiencies in the core competencies of urban management are only too apparent.

*Poor, government controlled regulatory environments*

*Weak institutional capacity*

**Jobs gap.** Numbers and skills are mismatched, and business-friendly environments are lacking. People often look for safe employment in the public sector. But governments do not generate productive jobs; the private sector does so through risk taking and entrepreneurship. In many cities, entrepreneurship is frustrated by excessive government bureaucracy, red tape, and regulation. Migrating rural populations have only the basic skills needed to gain a foothold in urban areas, and despite job shortages, unemployment and underemployment remain persistently high.

*Substantial mismatches of skills*

**Opportunity gap.** Many parts of cities, especially the informal “arrival areas,” lack appropriate access to basic services. Water supply, sanitation, and waste management are poor; access to social services is limited; connections to the wider city are inadequate; and business services and entrepreneurial finance are absent. Compounding this is insecure land tenure. Inadequate and inappropriate buyers’ finance, and wrongly directed subsidies characterize the low-income housing market. Formal low-income housing in most cities is built by the public sector, and because of costly construction and relatively high standards, most units are unaffordable without substantial subsidies. Furthermore, the scale of need and the subsidies are beyond the resources of most governments. The dearth of affordable middle-income housing also leads to the “crowding out” of the urban poor from many public sector schemes.

*Lack opportunities for the poor*

**Sustainability gap.** Natural ecosystems are under stress because of urbanization. Waterways are filthy and often blocked with garbage; air is polluted by emissions from factories and motor vehicles; and streets are strewn with waste. Too little is done to tackle these problems. Cities need more green space, less air and water pollution, and better planning and new technology to reduce the demand for fossil fuels.

*Ecosystems under tremendous stress*

**Infrastructure gap.** Gaps exist in both facilities—assets—and service delivery—operation and maintenance. Priority is generally given to the construction of new infrastructure. It is more politically acceptable to open a new road or sanitary landfill site than it is to improve the maintenance of an existing asset. As a result, maintenance is generally poor, and the useful lives of assets are reduced. Exacerbating the gap is the competition for resources between and within the construction of strategic assets—roads versus mass transit systems, solid waste disposal, sewers, and trunk drainage, for example—and local neighborhood infrastructure—urban upgrading.

*Huge infrastructure deficits*

*Poor service delivery*

**Finance gap.** Estimates are that to improve Asian cities, some \$100 billion is needed each year, but only \$40 billion is currently being raised and spent. How is the \$60 billion gap to be funded? In most cities, infrastructure spending is generally financed by national governments with official development assistance (ODA). Investment programs need to be scaled up massively, but who will provide the financing? The formal private sector is not yet involved in a major way, although it has the resources, expertise, and efficiency to do so. Many communities do not invest in local infrastructure improvements, despite the successful community-based programs that have been scaled up to the city-wide level—the Kampung Improvement Program in Indonesia, for example.

*A \$60 billion annual funding gap*

**How can we bridge these gaps?**

## Incentives to Bridge the Gaps—The Carrots and the Sticks

Incentives are stimuli to motivate people and organizations to operate in a certain way. In cities, they play an important role in aligning public and private interests. Incentives enable private actors to behave in ways that benefit the public good. But to change behavior, the central objective, incentives need to be large enough to encourage a response. A simple and clear incentive is more likely to generate a stronger response. But sometimes incentives can have the opposite effect—they cost a lot and can be difficult to remove once enacted, even if unsuccessful. However, experience shows that effective policies, if backed up by well-designed and transparent incentives, can turn around a city's fortunes, often in less than 10 years (Box 7).

*Incentives are needed to encourage behavioral change*

### Box 7: How Can We Design Effective Incentives for Growth?

Seven rules when creating financial incentives—they should

- be sufficiently large to generate a response,
- affect decisions at the margin,
- have no thresholds,
- incentivize the intended behavior,
- target the appropriate decision maker,
- be easy to understand and transparent, and
- be predictable and long-term.



Source: Room for Improvement: Creating Financial Incentives Needed for Economic Growth. Centre for Cities. July 2011.

### *Bridging the policy and regulatory gap—long-term planning*

At the national level there are few effective coordinating and policy-making bodies that engage major stakeholders. National urban development ministries or agencies seldom engage communities or the private sector in an effective way. Most countries lack a long-term vision for the urban sector. More effective coordination, forward thinking, and long-term planning are required everywhere to ensure that appropriate policies and incentives are implemented. An urban sector vision is required.

*This requires:  
A long-term vision for the urban sector*

### *Bridging the institutional capacity gap—coordination and capacity development*

Most Asian countries have fragmented urban management structures that split responsibilities among various layers of government and different infrastructure agencies for housing, transport, and utility services. Coordination is problematic, which can lead to duplication of efforts, and in some cases turf wars. Establishing or strengthening urban sector apex agencies is required (Box 8).

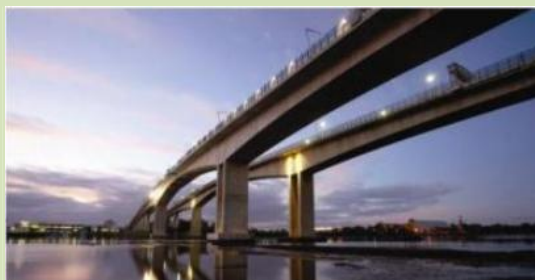
*Creation of apex agencies to facilitate urban development*

### Box 8: Building Australia Together—Infrastructure Partnerships Australia

An example of an apex infrastructure body involving the public and private sectors is Infrastructure Partnerships Australia (IPA). Launched in 2005, IPA advocates solutions to the nation's infrastructure challenges through dialogue and partnerships.

- IPA brings together the public and private sectors to promote best practice in the identification, design, and delivery of national infrastructure assets and services.
- It provides a forum for decision makers, and ensures advocacy and focus on national infrastructure frameworks—irrespective of commercial or political considerations.
- Its membership comprises senior infrastructure industry leaders—construction companies, operators, designers, financiers, and key government departments and agencies.

Through its expertise, IPA has shaped the national debate to encourage the delivery of world class infrastructure and services.



Source: Infrastructure Partnerships Australia. Website: [www.infrastructure.org.au](http://www.infrastructure.org.au)

Also, at the local level there is a lack of coordination. Even neighboring local governments sometimes find it difficult to work together. Peri-urban development and urban sprawl cross municipal boundaries, making the retrofitting of infrastructure and collecting appropriate taxes and charges difficult. These problems are even more pronounced where mega cities have engulfed other cities, towns, and villages. Creating a single governing body responsible and accountable for results on a city-wide basis is necessary.

*Establishing single governing bodies for cities*

Most cities have run-down areas, generally in the older and more historic parts and in informal settlements mainly on the urban fringe. Regeneration, renewal, or upgrading of these areas is necessary, but too few resources mean that this takes place on a piecemeal basis. The focus of urban renewal or regeneration is probably best when related to small, run-down areas or districts of cities, and, when area-specific special purpose vehicles (SPVs) are set up involving the private sector and communities. However, solutions should also involve relaxing planning regulations and providing tax breaks to stimulate development and job growth. Strict planning regulations also hinder development—they can be antibusiness and antijobs. In many areas where they have been relaxed, considerable development has taken place. The United Kingdom has led the way through its urban regeneration companies (Box 9).

*Renewal and upgrading of rundown areas and of informal settlements*

#### **Box 9: Urban Regeneration Companies in the United Kingdom**

Examples of a special purpose vehicles set up to achieve transformation of depressed areas and stimulate investment are the urban regeneration companies (URCs) of the United Kingdom. They bring together the public and private sectors as partners.

- URCs are independent companies established by the local authority and the former regional development agencies, although the form is not prescribed and is determined locally.
- They have a governing Board with a Chair, and most members are from the private sector. This structure, with a focus on public consultation, helps to cement links among public sector agencies, businesses, and citizens.
- URCs engage the private sector in a sustainable regeneration strategy, working within a masterplan that focuses the problems and opportunities of the area.
- Today, there are four URCs in England and others in Scotland and Wales.
- Recently, city development companies (CDCs) were set up, and later rebranded as economic development companies (EDCs), to drive economic growth and regeneration beyond urban centers. They are based on rural areas, coastal areas, or subregions.
- Some URCs became EDCs or CDCs following the review of regional economic development and regeneration in 2008.



Source: *Homes and Communities Agencies website: [www.homesandcommunities.co.uk](http://www.homesandcommunities.co.uk)*

The emphasis of capacity development in the past has been largely on training, but overall, it has not been very successful. Trained staff either leave for better paid employment or are never put in a position to use the knowledge acquired. The issue of low salaries, so prevalent in Asian governments, has never really been tackled. But this needs to be seen within the context of a bloated public sector, both nationally and locally. A major dilemma is how to incentivize staff reductions that would allow for significant salary increases for those more deserving. Evidence from the developed world, however, shows that paying the public sector exceedingly well does not necessarily lead to better service delivery. Whatever the size of the public sector, attitudinal change towards citizens and business is required. This must focus on the “service” element of public service.

*Improving salaries and skills*

*Responsible financial management*

## ***Bridging the jobs and opportunity gaps—towards more competitive and inclusive cities***

To increase city competitiveness, inclusion, and greening, we need to adopt incentives for better governance, to enhance capacity, and to raise additional finance. The incentives can be monetary, fiscal, spatial, or legal.

Incentives to improve city competitiveness generally cover cash or near-cash assistance provided on a discretionary basis to attract or retain business within certain areas. They can be exemptions and relief from local and national regulations—planning, taxation, employment, and business registration, for example—or involve the construction of public infrastructure. The goal is to encourage job growth, business, and investment often, but not exclusively, in blighted or run-down districts, while also generating long-term tax revenues.

For cities to fulfill their potential, the broader economic policy environment needs to provide the right incentives that encourage productive and sustainable growth. This usually involves two priorities: first, the dismantling of long-standing regulatory barriers to productivity and growth in the manufacturing and service sectors; and second, making better use of natural resources. If restrictive labor rules and sector-specific regulations persist, they can limit the capacity of more productive companies to expand. High social taxes and stringent job security laws make firing of redundant employees difficult and employers reluctant to hire. Incentives to reduce the cost of formal employment—lower labor taxes—and to increase the risk of noncompliance—better monitoring and inclusion of informal operations—would bring informal operators into the formal sector, create more productive service jobs, and generate additional tax revenues.

But the groundwork for strong local economic performance also requires transparent land ownership and zoning regulations, reliable infrastructure, efficient intercity transport networks, effective collaboration with the private sector, and strong links between academia and business. Inclusive cities imply the creation of a high quality of life, which means better public safety, more accessible housing, efficient public transport, and high-quality education. This also involves PPPs to improve access to public services, especially when public management capabilities and financing fall short. To make cities environmentally sound requires improving energy productivity, setting green standards, more efficient movement of people and goods, and making public utilities and service delivery more efficient.

An enlightened land management policy that enables property to be available when needed is a prerequisite for financing and implementing bankable projects, giving cities more freedom to act. If cities can invest in infrastructure, land, and managerial capacity to anticipate demand arising from expected population growth, this can lead to sustained improvements in living standards.

## ***Bridging the sustainability, infrastructure, and finance gaps—local government finance***

Low rates of investment are barriers to city growth, but interestingly, the majority of urban development financing is from outside government—informal settlements built by private families, formal housing built by private developers, and commercial and industrial premises constructed by the private sector. Most of these include onsite infrastructure. Much of this is funded by local banks, mortgage companies, individual savings, and microfinance agencies. However, the adoption of more flexible planning rules and standards is necessary to encourage even greater involvement of the private sector.

***Incentives to increase competitiveness require:***

***Dismantling regulatory barriers***

***Better use of natural resources***

***Measures to reduce the cost of formal employment***

***Transparent land ownership, better infrastructure, intercity networks, collaboration with private sector, and links between business and academia***

***Better long-term planning***

***Much of the growth of our cities is private sector led***

Most local governments are able to finance small, neighborhood infrastructure improvements, but their resources are inadequate for major trunk or strategic investments. These are generally left to the national government line agencies or, in a few cases, to larger metropolitan governments or development authorities. Multi- and bilateral agencies, through ODA, often provide governments with funds for such infrastructure—but even this is insufficient to satisfy demand.

*Financing strategic infrastructure often relies on ODA funding*

A key aspect of central government fiscal policy is for local governments to maximize revenue potential. This involves collecting higher property taxes, imposing economic charges for the use of publically funded services and utilities, and PPPs that mobilize public and private capital and benefit from private sector expertise in using resources more efficiently and minimizing risks.

*More revenues enable local governments to borrow*

By expanding local revenue coverage—the tax or charge base—increasing rates, and enhancing collections, local governments are able to improve their financial standing. This also enables them to borrow. Improved cost recovery provides guaranteed revenue streams against which borrowing becomes possible. But debt financing requires local governments to be more transparent concerning their finances and to demonstrate fiscal stability. Improved creditworthiness and higher ratings are the key.

A major source of local revenues in developed countries is property taxation, but its potential in the developing world has still to be maximized. Taxation based on the value of land is best, rather than on what is built on it. If rates are kept low and values assessed at or near market rates, considerable inflation-proof revenues can accrue.

*Enhanced property taxation is crucial*

Local governments should also be able to capture some of the land value increases that stem from investment in public infrastructure and other facilities. Seldom are these realized on account of the infrequent revaluation of property, the lack of effective mechanisms, and a reluctance to charge land owners. Betterment levies are included in most local government laws and regulations but are seldom used because of a general unwillingness to impose them.

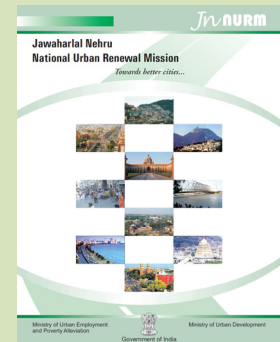
Alternative approaches are required that involve cooperation with landowners, perhaps by binding them into development schemes in advance. This could also avoid government having to buy all of the land it needs for infrastructure. The principle of planning gain, where landowners and developers provide land and/or facilities for a local government in exchange for planning approval, is used in developed countries to great effect.

Most central transfers remain formula driven and provide no real incentive for local governments to improve performance or increase revenues. Transfers—or at least a component of them—need to be more focused on improving local government performance. They also need to achieve the most “bang for the buck” by encouraging local governments to increase local resources and leverage those of the private sector. One such example is the Jawaharlal Nehru National Urban Renewal Mission in India (Box 10).

### Box 10: Jawaharlal Nehru National Urban Renewal Mission (JNNURM), India

A reasonably successful pilot program for incentivizing local governments is the JNNURM, which relates central transfers to improvements in local governments. JNNURM is a 7-year program, launched in 2005. It provides substantial central government financial assistance to cities for infrastructure, housing, and capacity development. Funds are allocated for specific projects in 65 “mission” cities under two components—urban infrastructure and governance improvements, and basic services for the urban poor. Two other programs are for nonmission cities—small and medium towns’ development, and housing and slum development. Total funding is about Rs 6.6 trillion (USD 13.3 billion). JNNURM aims to encourage urban sector reforms to strengthen municipal governance in accordance with the 74<sup>th</sup> Constitutional Amendment Act of 1992.

- Assistance is provided after the approval of a city development plan (CDP), and the identification of major projects that follow the priorities of the CDP.
- Thirteen specific reforms are mandatory for states and municipalities before funds can be accessed.
- Municipal-level reforms include the adoption of modern accounting systems, improvements in property tax collection, better cost recovery for utilities, and targeting investments to the poor.
- State-level reforms include implementing decentralization measures, and enacting laws for community participation and public disclosure.
- Funding is provided by national and state governments, and the local government—from its own revenues or through borrowing—based on a formula that classifies cities into three groups according to broad population ranges.



Disbursements were slow to start because of a lack of viable projects. Progress in implementing reforms has also been slow, since it proved difficult to enforce conditionality under a project-based funding approach. The mission has exposed a lack of capacity within local governments to prepare and implement infrastructure projects. However, under the JNNURM and the 74<sup>th</sup> Amendment, India commenced urban reform. JNNURM needs strengthening and many more resources.

Sources: *Report on Indian Urban Infrastructure and Services. High Powered Expert Committee for Estimating the Investment Requirements for Urban Infrastructure Services. March 2011. India’s Urban Awakening. McKinsey Global Institute. April 2010.*

Other incentives can follow a challenge fund-type of mechanism, where funds are granted if certain conditions are satisfied. The Philippines Performance Challenge Fund is an example of a recent pilot project that follows this principle (Box 11).

### Box 11: The Philippine Performance Challenge Fund for Local Government Units

This pilot scheme provides counterpart funding to local governments for capital investment projects. It seeks to rationalize intergovernmental transfers to support good governance, encourage the alignment of local development initiatives with the national government development agenda and priorities, and assist poor local governments in developing and implementing economic development and poverty reduction projects.

The grant fund is open to all provinces, cities, and municipalities that comply with the eligibility criteria necessary to secure a Seal of Good Housekeeping.

These criteria relate to sound fiscal management—absence of adverse chart of account opinion on their financial statements; and transparent and accountable governance—full disclosure.

Local governments are targeted according to income class or indicators of fiscal need—income or internal revenue allotment per capita, poverty incidence, or classification.

Priority is given to low-income local governments, and those with high incidences of poverty.

Source: *Department of Interior and Local Government website: www.dilg.gov.ph*



There are many modes of financing for climate change and environmental projects. These usually supplement other financing sources and rarely cover the full cost of an investment, but they can make the difference between viability and nonviability. Examples include

- nationally agreed upon mitigation action funds;
- clean development mechanism and bilateral cap-and-trade systems, such as those in Japan and Republic of Korea;
- climate investment funds that offer financing to improve fuel economy standards, accelerate fuel switching, and promote shifts to public transport in large metropolitan areas;
- the Global Environment Facility;

*At the macro level, a lot of financing is available for climate change and environmental projects*

- pooled funds for investments in projects with social, environmental, or other ethical considerations;
- export credit agencies; and
- a number of Asian Development Bank (ADB) facilities.

One or more of these funding sources can be used in a project if appropriate measures are taken during preparation.

At the micro level, incentives to reduce the energy consumption of buildings, industry, and transportation and to minimize waste generation work best when they involve reduced taxes; rebates or refunds to encourage the installation of more efficient facilities; reuse of commodities; and reduction, reuse, and recycling of waste. But most cities have adopted “penalties” for those who continue to pollute, including emission/effluent charges based on quality or quantity of waste produced; and charges on products that pollute or damage the environment during or after consumption. More market-based solutions have also been adopted, including tradable rights for the use of resources, and marketable permits to minimize waste generation.

*Incentives and penalties at the local level encourage green development*

Improving cost recovery for utilities—direct user charges, taxes, and fees—is a key component of local government financial reform. This implies the adoption of economic and inflation-based pricing for utilities and services, ensuring that all those who are served pay, and that arrears are kept to a minimum. This requires effective systems for billing and collection, reinforced by incentives for prompt payment and the implementation of strict enforcement procedures. But enforcement needs to be profitable, and enlightened reward systems are necessary. Ring fencing revenues (keeping revenues from unbundled components separate from the larger system) and encouraging local governments to get out of the utility business through commercialization and bringing in the private sector are necessary. The first steps involve corporatizing utility entities and creating a truly independent regulatory environment. This can lead either to entirely privatized utilities or having them run under PPP arrangements.

*Commercializing utilities and adopting PPPs is necessary*

### ***Bridging the sustainability, infrastructure, and finance gaps— incentivizing private sector finance***

Private sector involvement has three aspects—the availability and feasibility of appropriate projects, the need for SPVs to implement these projects, and available finance to fund the SPVs and projects. Some countries are more supportive of PPPs than others, but in all there is still much to do. Regulatory regimes need to be introduced or, where they exist, made much more independent of government. However, all governments must learn from successful PPP ventures, and private partners need to be more aware of the opportunities offered by, and become more familiar with, PPP arrangements.

*Private sector participation requires projects, SPVs, and finance*

Infrastructure projects must be identified within the context of a strategic city development plan, and their suitability for private sector participation properly assessed. Feasibility studies need to be reoriented towards those required for private sector investment. Simpler and more concise studies that thoroughly assess financial and institutional risks, and structure a project for private sector participation are needed. Resources and mechanisms are also needed to ensure that feasibility studies can be funded. This could be through a revolving fund initially capitalized by financing institutions or governments or both, and reimbursed by the sponsors of projects achieving financial closure.

*Projects need to be selected on the basis of long-term strategic goals and their viability*

To implement such projects through PPPs, SPVs need to be set up. But in many countries, restrictions on the private ownership of public utilities, ineffective procurement laws, and poor knowledge and experience mean that the legal basis for SPV establishment is lacking. Rules and regulations for setting up joint ventures, too, are either lacking or unworkable. Drafting and approving legislation to set up SPVs and removing restrictions on the ownership of public utility companies and land should be the first priority.

Bringing in private finance requires incentives to encourage supply-side institutions—pension funds, insurance companies, commercial and investment banks—to fund urban infrastructure. They should be major investors in public infrastructure projects, but many are not. The nature of such funds requires secure and low-risk but profitable investments. Incentives, through guarantees, availability payments, or covered bonds, for example, could be provided to encourage the managers of mutual and other private funds to invest in urban infrastructure.

Appropriate financial structuring of a project is the key. Risks are higher during the design and construction stage, lower once revenues streams come on line and are shown to be robust. Infrastructure development financing is needed for the first 5–7 years of a project only, not necessarily for the 15–20 years of its life. Refinancing should become routine after a few years of operation.

*Appropriate financial structuring of projects is necessary*

Covered bonds, which typically pool loans given to regional and local governments, or PPPs, which often carry a government guarantee, are one approach. They finance projects such as roads, bridges, high-speed rail, hospitals, schools, and utilities. By pooling retail loans and issuing covered bonds, banks are able to attract large amounts of global capital. Covered bonds originated in the European bond market as an instrument for purchasing mortgage loans or public debt, including infrastructure. Since 2000, loans for infrastructure have become more common, and in 2009 they represented over 25% of all covered bonds issued. Some 27 European countries now have a regulatory framework for such bonds. But Asian countries need to ensure that similar frameworks are in place before financing institutions will issue these instruments. Covered bonds are attractive to investors looking for high-quality instruments that offer positive yields.

Other incentives could follow the United Kingdom Public Finance Initiative (PFI) model, under which private companies are building and in some cases operating social infrastructure facilities such as prisons, hospitals, and schools. Incentives are the availability payments made by the government to a private company in lieu of direct revenues (Box 12). The PFI effectively defers capital investment financing for the government and enables payments over time.

*Availability payments can be used as incentives for private sector participation*

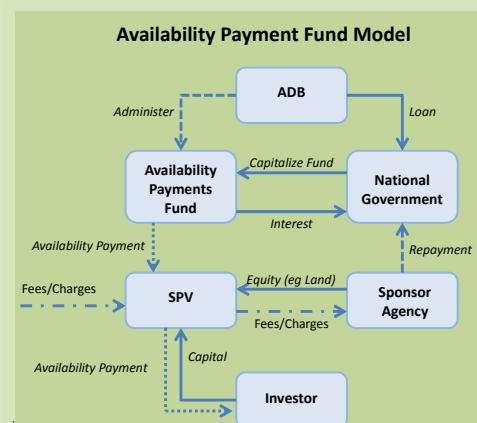
But potential projects for private sector participation need to pass a value-for-money assessment. And this can be difficult when comparing a government’s ability to borrow cheaply against that of a private sponsor. And higher discount rates are usually needed for private sector projects than for government ones, which often means lower value for money. The difficulties are compounded when governments access ODA loans at low interest rates.

### Box 12: Availability Payments

An availability payment is a periodic transfer made to a concessionaire by a public authority for providing an “available” facility. Payments are reduced if the facility is not always available, or not being maintained as agreed. Availability payments eliminate demand and revenue risks and protect the public interest through financial incentives to concessionaires to maintain facilities properly and operate them at a specified level of performance. They offer a number of benefits:

- There is long-term budget certainty for the public owner.
- Payments start at project operation, incentivizing the private partner to complete soonest.
- Private operators are focused on meeting a specified standard of service.
- The public partner has control over user fees or revenues
- Maintenance and future capital renewal and replacement costs are fully funded.
- Cash flows to private partners are more stable than with user fee concessions, thus reducing debt costs.

The ADB financed Climate Public-Private Partnership Fund has adopted the approach and enabled the implementation of environmental and social infrastructure projects by leveraging international and domestic finance.



Source: *Innovations in Financing Subsovereign Infrastructure*. ADB internal paper. Draft March 2011.

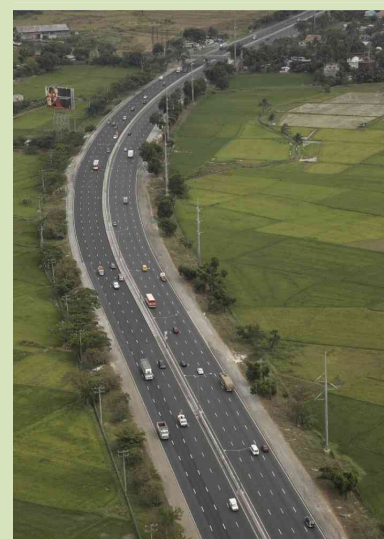
However, banks do not tend to lend to projects; they lend to sponsors of projects, which are the owners of SPVs or are the SPVs themselves. Successful PPPs involve companies that have the experience and a satisfactory credit rating, partnering with governments.

A number of private infrastructure companies function in Asia. Some are involved in developing and operating toll roads; others run utilities, telecommunications, and public transport (Box 13). A number have entered into concession agreements to operate and expand public utilities, including build-operate-transfer arrangements, especially in the water utility sector. Others are shareholders of utility, telecommunications, and electricity companies. Many have become infrastructure investment or holding companies. Quite often, SPVs are owned by a consortium of these companies and other investors. All, however, are looking for new investment opportunities in urban infrastructure. Access to this vast market needs to be incentivized by government through the identification, prioritization, and bidding of projects. But this requires rigorous feasibility studies.

### Box 13: ADB's Catalytic Role in the North Luzon Expressway Project

An example of a successful project structured during a time of financial uncertainty and implemented through an SPV, the Manila North Tollways Corporation (MNTC), involved the rehabilitation of the 84-km North Luzon Expressway (NLEX) between Manila and the Clark Special Economic Zone in the Philippines. The expressway was in poor shape, and the government looked to the private sector to take over the operating franchise held by the government-owned Philippine National Construction Company (PNCC).

- The rehabilitation project was structured as a PPP, and undertaken on a rehabilitate-operate-transfer basis by MNTC.
- MNTC was incorporated in 1997 by the Lopez Group of companies and the government's PNCC.
- PNCC had problems in raising funds, and sold its shares in MNTC to Egis Projects SA and Leighton International Limited (LIL) between 2001 and 2003.
- In 2007, the companies within the Lopez Group sold their shares in MNTC to Metro Pacific Investments Corporation.
- 2009 saw the sale of LIL's shares to Globalfund Holdings, Inc, and in 2010 to Banco De Oro Unibank, Inc.
- The various transfers of ownership occurred without any serious disruption of the activities of MNTC.
- Total project cost was \$384 million, financed with loans of \$267 million from international commercial banks, multilateral institutions, and export credit agencies, including \$70 million from ADB and \$45 million from the International Finance Corporation, and equity of \$117 million from MNTC's shareholders.
- ADB played a key role in the closure of the project finance transaction in 2000, and catalyzed commercial financing at a time when banking institutions had little appetite for toll road projects so soon after the Asian financial crisis.



The project's successful financial structuring, its subsequent refinancing, and the paying down of outstanding credit facilities early demonstrated the financial viability of tollway rehabilitation and operations. Before the project there was little interest of the private sector investing in toll roads, but afterwards attitudes changed when the project demonstrated the practicality, acceptability, and viability of toll roads.

*Source: ADB internal evaluation reports on the North Luzon Expressway Project. 2011.*

## Moving Forward—What Governments and the International Community Can Do

The scale of urbanization and the role that mega and medium-sized cities will assume create significant new opportunities for the private sector around Asia. Business should play a major role in the dynamic development of an expanding urban market, not only through job creation and enterprise but also by investing in and operating urban infrastructure. The policy, regulatory, institutional, capacity, jobs, opportunity, sustainability, infrastructure, and finance gaps are such that governments cannot act alone.

*The scale of investment needed is massive*

Governments first need to recognize that the private sector has a major role to play, and urban policies should reinforce this. Not only does this require the participation of formal banking and financial institutions, but it also should involve infrastructure contractors, operators, and designers. There are significant resources placed in pension funds, and these and other capital market institutions are seeking new investment opportunities that offer low risk and long-term involvement.

*Governments have to recognize that the private sector must be involved much more*

Much has been written in the past about private sector investment, but too little has been accomplished. A major strategic policy shift is needed—one that recognizes that the private sector is an equal, if not a leading, partner in urban development. Changing micro elements of policy—a little shift here, a little one there—is not the way.

*Governments should accept the private sector as an equal partner*

Macro actions are needed to overcome the key constraints that inhibit private sector investment in urban infrastructure. These relate to the following:

- Projects—the insufficient number of bankable urban infrastructure projects that have been appropriately prepared, structured, and shown to be viable for debt and/or private financing
- Risk mitigation and credit enhancement—the limited financial resources available within the public sector, and the inability of national and local governments to finance projects through debt
- Equity—the lack of systemic private equity funding for urban infrastructure
- Land—the persistent difficulties over land acquisition

*Overcome the major constraints that inhibit private sector involvement*

Overcoming these constraints requires incentives and mechanisms to

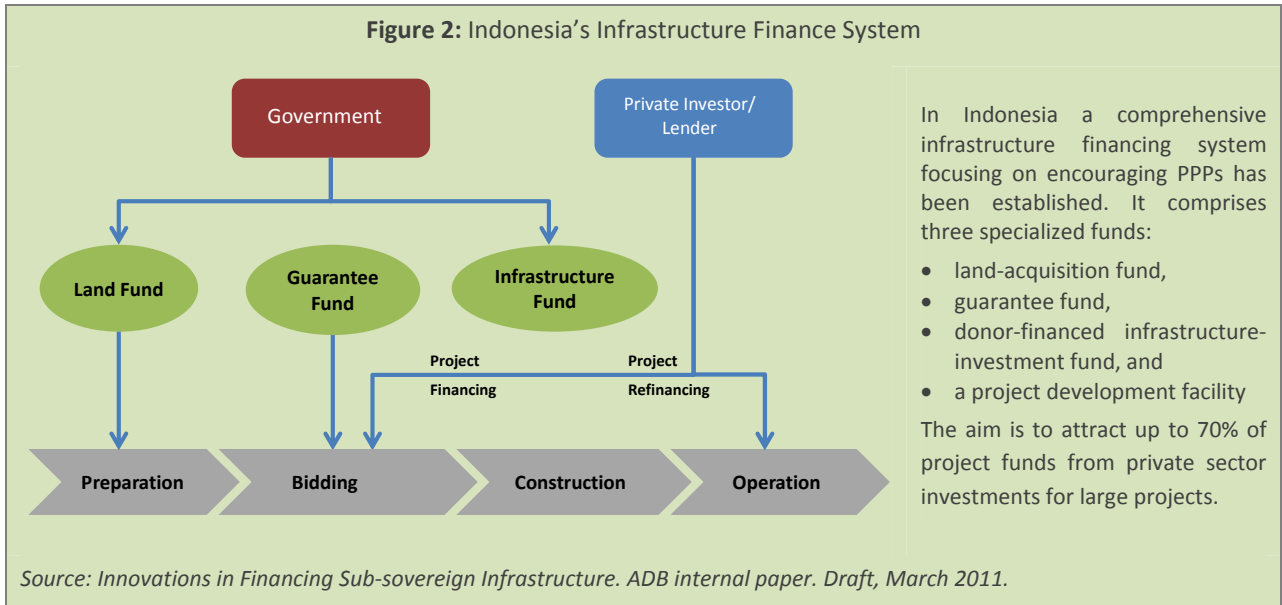
- encourage better and more integrated land use and transport planning; and the identification, preparation, and financial structuring of urban infrastructure and renewal projects;
- improve the financial condition of local governments through incentivizing performance, encouraging local revenue generation, and enhancing competencies in urban management—making local governments more creditworthy;
- channel long-term finance from capital market institutions, including pension funds and life assurance companies, into infrastructure development; and
- encourage the more efficient use of land—better planning, taxation, regulation, and enforcement to ensure its availability for strategic infrastructure projects by either the value gained through changes in land-use designation, land sharing, voluntary sale, or the use of eminent domain legislation.

*Incentives are required for more integrated land use and transport planning, structuring projects, improving the financial condition of local governments, channeling long-term finance from capital markets, and encouraging better use of land*

National governments need to assist local governments to overcome the macro constraints. They need to provide incentives to ensure that local governments become proactive and efficient urban management bodies, capable of developing projects, building their own financial capacity, and able to access capital market finance. National governments must create appropriate enabling environments that include legislation to set up SPVs for PPPs, design an appropriate infrastructure financing system, and establish independent regulatory regimes outside government structures. For example, Indonesia has an innovative infrastructure finance system that aims to attract private sector investment (see Figure 2). National governments should become the distributors of best city practices, encourage pilot projects, and aggressively promote the take-up of new solutions.

*Governments should provide incentives to encourage local authorities to be more proactive, develop projects, build financial capacity, and access capital markets*

**Figure 2: Indonesia's Infrastructure Finance System**



Regional development institutions, including ADB, need to support national and local governments towards achieving the above, and to engage them and the private sector in high-level policy dialogue on urban issues and solutions. Regional mechanisms, such as the Cities Development Initiative for Asia, should be strengthened and made more sustainable to support national and local governments in these efforts.

***ADB and CDIA should support governments achieve the above***

CDIA is supported by:



BMZ

Federal Ministry  
for Economic Cooperation  
and Development

