

‘Billions to trillions’ with concessional finance

by Craig Sugden

9 June 2017



Jim Yong Kim speaking at World Bank/IMF 2017 Spring Meetings (World Bank/Flickr CC BY-NC-ND 2.0)

In April, World Bank Group President Jim Yong Kim renewed the call for [fundamental change in the approach to development finance](#). To turn ‘billions’ in official development assistance into ‘trillions’ in public and private investment, Kim argued that development finance institutions should be working harder to crowd in private capital.

Kim highlighted the fixes needed within the World Bank and development finance institutions, such as correcting incentive structures that encourage quick lending, and serving as a strategic advisor rather than a lender.

These messages were reinforced later in the month by the [2017 Global Infrastructure Forum](#), a grouping of multilateral development banks (MDBs). They also emphasized the primacy of country ownership.

How can developing economies engage in the transformation called for by Kim, and make sure they enjoy the potential benefits?

One essential action is to keep asking for advisory support to prepare projects well and to strengthen enabling environments for private investment. Getting governance standards right is especially important to attracting private finance.

Developing economies can also update how they use concessional finance, the mainstay of the MDBs. Take as an example how concessional finance can be used in public-private partnerships (PPPs).

The PPP is an increasingly popular tool for delivering public services in cooperation with the private sector—developing economies are now closing more than \$100 billion worth of [infrastructure PPPs annually](#). Maturing operational frameworks for PPPs are helping, as is the wider acceptance of PPPs among stakeholders that comes with experience, bolstered by rising interest by governments in mobilizing new sources of finance. PPP activity is ramping up to fill infrastructure gaps, and to

deliver much needed social services like education, health, and elderly care.

Those new to PPPs often expect them to work without government financial support. A common view is that PPPs avoid the need for budget funds, and so concessional finance is unnecessary.

Many of the early PPPs did work without government finance support because they were concentrated in facilities with high user revenue. Some of today's PPPs are still like this.

But the modern PPP normally incorporates some government financial support. User charges are often kept below costs for economic development or social reasons, and governments need to cover the short-fall. For example, when PPPs provide services to the poor and others that lack an ability to pay, governments must pay on their behalf.

Government financial support can be also required to achieve pragmatic risk allocations. Asking the private partner to carry a risk that it cannot control can result in a PPP being too costly or even unviable. Managing demand risk has proven to be especially challenging. For example, Australian road PPPs that relied on tolls to generate profits were rendered un-bankable by a series of large losses resulting from lower than expected usage. Governments often carry some demand risk in PPPs, such as via prudent contributions of project revenue, which gives rise to a financial commitment.

Concessional finance is an ideal source of government financial support to PPPs. Well targeted concessional finance can provide a foundation that makes projects commercially viable, which in turn allows a private partner to secure finance. This is the main way that concessional finance can crowd in private investment.

When financing conventional public investment, concessional finance pays a contractor's invoices during construction. There are no such invoices for PPPs, and concessional finance must be used in a different way. Here are three good options:

(i) Financing viability gap payments. These payments meet the gap between project costs and user revenue so that a project is commercially viable. India has been one of the leading proponents of their use. Viability gaps payments are a capital grant, and are often made from viability gap funds. Developing economies could ask for help with such funds or seek concessional finance for viability gap payments on a project-by-project basis;

(ii) Financing availability payments. These are payments made during a project's operation phase by government to the private partner. They are based on the

availability of the contracted service; hence the name. Availability payments are common in PPPs—over 80% of PPPs closed in Europe in 2016 were government-pay PPPs, mostly based on availability payments. A smart option for developing economies is to front-load some availability payments at the start of operations and pay these using concessional finance. This allows the private partner to repay some of the debt raised for construction (say 25%). It trims back the need for long term private financing, which can be costly and difficult to secure in emerging economies over the 10, 20 or 30 years of the operation phase; and

(iii) Guaranteeing government commitments, such as availability payments. Private partners to PPPs and their financiers often request letters of comfort from the ministry of finance or guarantees from state-owned financial institutions. Guarantees from a credit-worthy, third party such as a MDB are much more valuable to the market, and can be surprisingly low cost.

It is important to keep in mind that MDBs offer more than just finance. They also ensure that PPPs meet good practices (e.g., are corruption-free). When they stand behind a PPP, the credibility of the PPP is enhanced in the eyes of the market. This is another way that MDBs can crowd in private finance.

These suggestions should not be taken as a recommendation to quickly sign-up PPPs. In too many countries, PPPs have led to fiscal stress and disillusionment in reform. But most of these problems have predictable causes—PPPs are after all not rocket science—that are fortunately avoidable provided there is the commitment to do projects well.

This post has looked how developing economies can own the changes underway in development financing. Exploring these and other ways that developing economies can update their engagement with the MDBs is essential if ‘billions’ are to be turned into ‘trillions’ and opportunities to grow economies and tackle poverty.

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