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Rebuilding Infrastructure

Policy Options for Attracting Private Funds after Conflict

Postconflict countries have had difficulty attracting private investment in infrastructure, and their growth and stability have suffered as a result. But the success of a few countries hints at policy initiatives that governments could pursue to close this destabilizing gap in investment. The emphasis should be on making sure that sector reforms go far enough, getting the timing and sequencing of the reforms right, reducing investor risk, and recognizing the importance of small-scale providers.

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This Note summarizes a discussion of policy options from a paper by Jordan Schwartz, Shelly Hahn, and Ian Bannon (2004). A companion Note reviews trends in postconflict flows of aid and private infrastructure investment (Schwartz and Halkyard 2006).

Countries emerging from conflict face an urgent need to reestablish basic infrastructure services, but they lack the public revenue, government capacity, and investor interest to do so. Although donors often generously support the early phases of reconstruction, postconflict governments are generally unable to efficiently absorb this aid. And in the face of urgent policy priorities in the immediate postconflict period, governments rarely focus on establishing a welcoming investment climate. Thus for the first few years after conflict, countries confront a bitter paradox: they can neither make full use of the donor funds suddenly available for reconstruction nor attract much private investment for infrastructure.[1]

While the challenges of reconstructing infrastructure are enormous, a few conflict-affected countries—El Salvador, Guatemala, Mozambique—have been comparatively successful. Their experiences point to policy decisions and investment approaches that can speed private participation in infrastructure and thus the contribution of the private sector to reconstruction and growth.

Traditional policy responses

Because postconflict countries tend to have little capacity to absorb aid, most early infrastructure projects take the form of donor-driven construction contracts for rehabilitation, often with provisions for interim or emergency operations. These projects usually are not linked to long-term strategies for service provision. Moreover, once the initial contract has run its course, they typically rely on preconflict legal arrangements and market structures.

In such countries as Afghanistan, Bosnia and Herzegovina, and Iraq early bilaterally sponsored infrastructure contracts have generally

been managed through military procurement, disconnected from the advisers, donors, and evolving public agencies that seek to establish long-term regulatory structures. Once the environment stabilizes, government agencies and state-owned enterprises are often reintroduced to take over operational responsibility. It is often only at this late stage that a postconflict government begins reviewing market structures (seeking competition, unbundling utilities, separating oversight from operations, asking agencies to retrench), puts regulatory agencies into place, and seeks private investors. Pushing through the reform agenda can be more difficult at this later stage because new vested interests will have emerged. Senior officials may have gained political leverage, and public servants will have gained opportunities for corruption through misprocurement, nepotism, and extortion. Whether manifested in the exorbitant cost of moving cargo through Sudan's state-owned river ports or corrupt procurement for El Salvador's water sector construction contracts, the opportunity cost of delayed reform is passed on to the citizens and businesses of postconflict countries.

Goal of reform: investment and efficiency, not cash

Emerging from conflict in the early 1990s, El Salvador, Guatemala, and Nicaragua all introduced reformed telecommunications legislation by 1996. A comparative analysis of these reforms provides several lessons about the importance of timing and approach in infrastructure reform in postconflict countries.[2]

El Salvador and Guatemala opted for rapid deregulation, while Nicaragua chose a slower, staged liberalization. Partly as a result, El Salvador and Guatemala have been able to mobilize more private investment than Nicaragua, and that has led to higher service penetration. El Salvador and Guatemala implemented legal and regulatory frameworks that gave investors greater protection from government intervention. Their regulatory entities were granted more autonomy than Nicaragua's and have operated under the principle of minimal regulation.

El Salvador and Guatemala also eliminated most regulatory barriers to entry once reforms began. Potential investors needed only to apply for authorization. And when the two countries privatized their national operators, neither offered an exclusivity period. By contrast, Nicaragua established several restrictions on market entry, such as exclusivity in fixed lines for the incumbent and a 49 percent cap on foreign ownership. The result: Nicaragua's incumbent operator had a much lower price per line value than those in the other two countries.

The experience of these countries suggests two main lessons for postconflict countries: eliminate as many regulatory risk factors and barriers to entry as possible; and avoid complex bidding arrangements meant to maximize the revenues from licenses, concessions, or asset sales.

While reconstruction generally coincides with a period of low revenue collection, the temptation to use privatization for budgetary windfalls may be misguided. Infrastructure investors will have to "fund" these up-front transfers through lower investments, higher tariffs, or both. This basic tradeoff between cash and exclusivity on the one hand, and investment on the other, is common across all sectors. The priority for postconflict governments should be to move quickly to create a regulatory environment that promotes private investment, competition, and consumer benefits.

Getting the timing and sequencing right

The timing of reforms may also be crucial. Stepped arrangements in the immediate postconflict period in conjunction with quick moves to establish sectoral legal and regulatory frameworks can help. Stepped arrangements could include a planned progression from modest forms of private participation in infrastructure (such as service or management contracts) to deeper forms (such as leases with investment contributions, concessions, or public-private partnerships). The first steps generally involve little investment risk for private operators and may be particularly attractive to national, regional, or diaspora-owned companies.

The arrangements that define the rehabilitation program should reflect the long-term interests of the sector. If a government accepts a large loan from a donor—even at a highly concessional rate—to rehabilitate a port cargo terminal, it may be wise to ensure that the loan agreements do not preclude future private participation in the port. The port's improved effi-

ciency will have a far greater value to the country's economic future than the interest rate savings on a concessional loan.

Reducing investor risk

Infrastructure investments are more sensitive to country risk than is general foreign direct investment—and they are especially sensitive to country risk in postconflict countries (see Schwartz and Halkyard 2006). Accordingly, donors and governments should work together to address the elements of political and economic risk within their control or influence.

One possible way to reduce investor risk is to "package" investment opportunities for dollar-earning tradable businesses (such as mining, forestry, or gas and oil) with related infrastructure investments. In Mozambique the government's packaging of infrastructure investment opportunities with the multibillion-dollar Mozal smelting plant had tremendous success despite the risky post–civil war environment. The port had to be rehabilitated for the benefit of the new plant, but guaranteed access for third-party cargo ensured that the benefits spread through the regional economy. Rail, road, electricity, and eventually telecommunications investments followed—all triggered to varying degrees by the anchor Mozal investment.

Large industrial and natural resource investments provide important and reliable demand for infrastructure. They can also be used to demonstrate good contractual faith and to stimulate reform of banking, property, and corporate laws and regulations that in turn benefit infrastructure operators and investors. Of course, blending regulated and nonregulated businesses and guaranteeing third-party access to dedicated infrastructure raise regulatory challenges, and these will require the attention of postconflict governments and donors.

Governments can also help reduce country risk by, for example, respecting payment obligations for publicly contracted goods and services and implementing regulations that allow the repatriation of capital. Donors can assist in reestablishing or deepening short-term finance, banking, and other capital markets. For risks that can only be mitigated, not reduced, donors can provide guarantees and insurance products.

Establishing an early track record in attracting private investments can have a positive demonstration effect for future investments. Since telecommunications operators are often the first investors to arrive in conflict-affected countries, reforms and regulatory approaches should facilitate their entry so that they may begin to influence investor perceptions.

Encouraging small-scale private providers

Small-scale providers of infrastructure services should also be encouraged, or at the very least not constrained or regulated out of business. Unregulated small-scale providers commonly emerge in conflict-affected countries to meet the pent-up demand of poor, rural, and peri-urban communities, especially in electricity and water supply. A recent study identified 49 countries with small private electricity providers, and 32 with small-scale water providers; more than half were conflict-affected countries (Kariuki and Schwartz 2005).

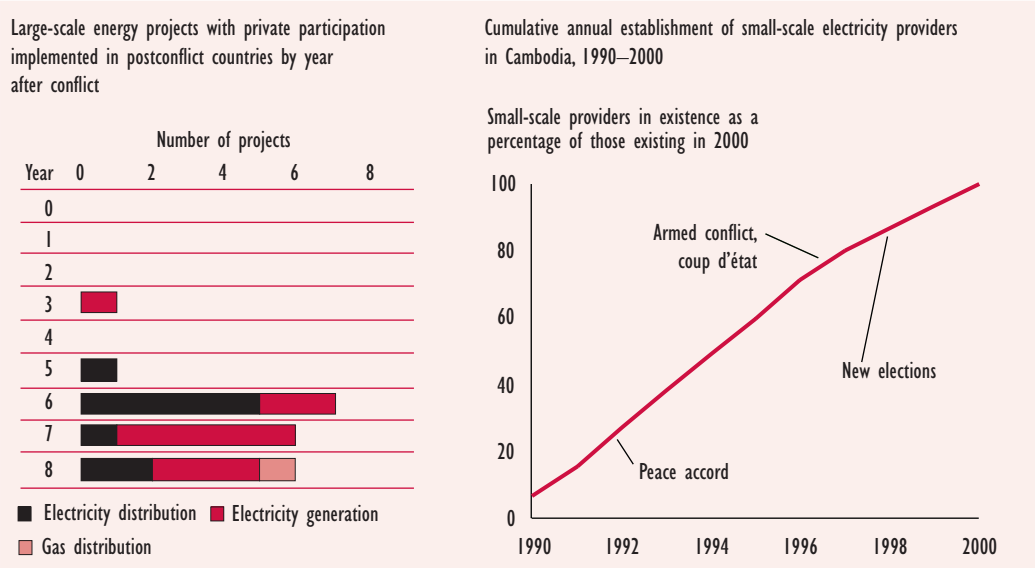
These providers can play a key role in the absence of established public utilities or major private operators. Their role can be especially important in postconflict countries, where large-scale electricity projects, for example, typically take six or seven years to materialize (figure 1). In Cambodia small-scale private electricity providers were established throughout the conflict period. The government's role in handling such providers can prove crucial to poor and isolated communities.

Some conclusions

Restoring basic services to households and businesses is a defining challenge of postconflict reconstruction. For a government or donor-led strategy to succeed, it must recognize the hazards of delays and false starts in sector reforms and the risk perceptions of potential private investors. Several policy options exist:

- Use large investment opportunities in tradable sectors to mobilize investments in infrastructure. This can be done by selectively packaging business licenses with (reasonable) obligations for service provision.
- Work to reduce country risk ratings by making contractual payments on time, enacting regulations that allow capital repatriation,

Figure 1 Energy projects and conflict



Note: Left-hand chart based on data for 10 countries that have emerged from war since 1990 and for which eight years of consistent data were available: Azerbaijan, Cambodia, El Salvador, Georgia, Lebanon, Mozambique, Nicaragua, Rwanda, Tajikistan, and the Republic of Yemen.
Source: For left-hand chart, World Bank, Private Participation in Infrastructure (PPI) Project Database; for right-hand chart, Enterprise Development Cambodia 2001.

and establishing an early track record in attracting private investment.

- Use guarantees and insurance products to mitigate risks ranging from revenue and traffic risk on the commercial side to expropriation, currency inconvertibility, war and civil disturbance, and even breach of contract on the policy side.
- Recognize the importance of small-scale private service providers. Possible ways to do this: provide support to financial intermediaries to extend financing, assist in developing licenses and other contractual arrangements that legitimize these businesses, and train community-based or local oversight bodies.

Notes

1. For a detailed discussion of this issue, see Schwartz and Halkyard (2006).
2. For detailed data on these country examples, see Schwartz, Hahn, and Bannon (2004).

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