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STRENGTHENING THE FOUNDATIONS FOR GROWTH AND PRIVATE SECTOR DEVELOPMENT: INVESTMENT CLIMATE AND INFRASTRUCTURE DEVELOPMENT

Attached for the October 2, 2004, Development Committee Meeting are two papers, prepared by the staff of the World Bank, to be considered under Item II of the Provisional Agenda:

"Strengthening the Foundations for Growth and Private Sector Development: Investment Climate and Infrastructure Development

a. Elements of the Growth Agenda: Investment Climate and Infrastructure
b. World Bank Group's Infrastructure Business: Update on the Implementation of the Infrastructure Action Plan," prepared by the staff of the World Bank."

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STRENGTHENING THE FOUNDATIONS FOR GROWTH AND PRIVATE SECTOR DEVELOPMENT : INVESTMENT CLIMATE AND INFRASTRUCTURE DEVELOPMENT

September 17, 2004

INTRODUCTION AND OVERVIEW

1. **Jobs, incomes and taxes generated by private firms are key to achieving the Millennium Development Goals (MDGs).** Without the dynamic force of private initiative, disciplined by competitive markets, economic productivity in developing countries will remain low and people stay poor. Private sector growth is a key to poverty alleviation because it generates the jobs and higher income that poor people need, as well as the tax revenues required to finance social programs that benefit poor people and help to supply a skilled workforce.

2. **Growth and private sector development is a broad agenda.** Sound macroeconomic policy, debt sustainability, open trade, security, access to finance and good governance are all key requirements for the private sector to flourish. These conditions need to be complemented by micro-economic reforms and infrastructure services that help to unleash competitive forces. Relevant actions by policy-makers in recent decades have focused heavily on improving macro-economic policies and certain structural reforms, such as trade policy and privatization. Progress in these areas has underpinned higher trend growth rates in emerging markets. At the same time, attention to the details of the microeconomic foundations -- the policies and institutions that support efficient private economic activity -- has been uneven. Similarly, more attention is required to meet the significant infrastructure needs in developing countries in order to enhance production options and trade as well as to help poor people access basic services.

3. **The pay-off for a heightened emphasis to job creation and growth through investment climate reforms and improved infrastructure services is likely to be significant.** *Doing Business in 2005* indicates that a hypothetical improvement to the top quartile of countries on the ease of doing business is associated with up to 2 percentage points more in annual economic growth. On the infrastructure front, estimates for Latin America in the 1990s suggest that a 10 per cent increase in infrastructure assets would increase growth by about 1.5 per cent per year. States in India with better infrastructure have seen higher long-term rates of poverty reduction. This is in contrast to the situation in some developed economies where a mature stock of infrastructure assets limits marginal economic gains. But even massive investments in infrastructure cannot compensate for inadequacies in the functioning of competitive markets, as the example of the Eastern States of Germany illustrates.

4. **Objectives and Scope of the Paper.** This note provides a brief overview of recent findings on the quality of the investment climate and policy effort, as well as on infrastructure service provision, which are informing the World Bank Group (WBG) approach to promote private sector-led growth and job creation. The paper does not elaborate on the status of specific WBG activities in this area nor address other development issues that are also critical for growth and poverty alleviation. Instead, the objective is to pose a series of strategic questions that can help frame a discussion on how best to refine and improve the WBG approach to investment climate reform and infrastructure service delivery.[1]

RECENT FINDINGS REGARDING THE INVESTMENT CLIMATE AND INFRASTRUCTURE

Investment Climate

5. **A good part of practical pro-poor growth policies is about bringing a better investment climate to areas where poor people live**. Cross-country studies suggest that differences between countries in levels of productivity, and hence incomes, are mostly due to differences in the quality of

[1] The findings are largely based on research by the WBG on firm-level investment climate surveys and the "Doing Business" project, summarized in the World Development Report 2005, and on infrastructure, as summarized in the Infrastructure Action Plan and related work.

institutions and policies, with investment in human and physical capital accounting for the remainder. Recent micro-studies try to shed light on the detailed dimensions of this to inform policy choices. The results of firm-level surveys for China and India, for example, show that the quality of the investment climate varies significantly by state, province or city. They also show that improvements in the details of investment climate tend to be associated with increased income levels and reduced poverty.

6. **Smaller and informal firms and farms, and hence poorer people, tend to benefit more than proportionately from improvements in the investment climate**. The small and medium-sized enterprise (SME) sector merits a particular focus in the WBG Private Sector Development (PSD) strategy for two reasons. It serves as a particularly critical link between the growth and poverty agenda as a critical supplier of jobs and investment. At the same time, SMEs – often composed of young and women entrepreneurs -- suffer disproportionately from some policy and institutional impediments in the investment climate, and have significantly less access to financial and other business development services than do larger corporations, which tend to have special connections and relationships that can overcome an inadequate legal and regulatory regime.

7. **When the investment climate is weak, many entrepreneurs and firms rationally stay informal.** For example, a recent detailed study of an IDA country found that relatively better educated people stayed in the informal sector to escape corruption and extortion. Particular benefit for the poorer segments of society results from reforms reducing the costs of becoming formal, while increasing the benefits from formality. Such reforms include reducing cost and time to establish businesses, reducing the cost from bureaucratic harassment, corruption and excessive taxation, while providing the benefits of property rights protection and contract enforcement. Institutional improvements like property rights protection tend to matter more, for example, than the provision of external finance per se. Support, for example, to small and medium enterprises tends to be effective when the policy and institutional environment is adequate – just as aid effectiveness more generally depends on sound institutions. In light of these findings, the WBG provides support for investment climate reform targeted to policies and institutions that disproportionately affect SMEs and complements this policy work by leveraging SME capacity building efforts and creating successful business models which provide demonstration effects.

8. **The detailed underpinnings of investment climate reform have too often been neglected**. The agenda for investment climate reform is vast, and includes the need to remove unjustified entry barriers for firms, particularly small and medium-sized enterprises; and strengthen the frameworks for competition policy, deregulation, and property and contracting rights. The push for regulatory simplification does not imply abolition of regulation, but it does call for a focus on enhancing the flexibility of markets and strengthening competition. Competition is key, through the ability of new firms to enter the market, good firms to grow and bad firms to fail. Survey data show that firms exposed to greater competition tend to be more productive and innovate more, that is, launch new products, upgrade products and introduce new technology. Firms that prosper because of special connections innovate less. Competition ensures that business-friendly policy translates into benefits for consumers and higher incomes. Access to finance is another key requirement. Here, an appropriate regulatory environment underpinning the collateral and credit information systems needed for firms to be able to access finance is a key element of an enabling environment for private sector investment.

9. **The new surveys on firm-level perceptions and performance provide further insights on the quality of regulations and infrastructure across and within countries.** For example, notwithstanding major emphasis on market-oriented reforms in Latin America, most countries in the region continue to maintain excessively complex regulations for business and have neglected investment in infrastructure. In East Asia on the other hand, most economies have made major strides in facilitating business, by lowering the cost and time of such processes as starting-up businesses, dealing with customs and enforcement of contracts and by improving physical infrastructure. China currently compares with Chile, while Brazil lags significantly, and Hong Kong and Singapore exemplify global best practice. African countries tend to suffer disproportionately from infrastructure deficiencies. At the same time they tend to have complicated and costly regulatory systems, surpassed only by several Latin

American countries. Meanwhile, in OECD countries, the greatest push for regulatory simplification is observed in countries such as Denmark, Finland, the Netherlands and Sweden. In sum, the broad patterns of the quality of business regulation and infrastructure provision are consistent with overall growth performance. At the same time improvements in the investment climate do not mean abandoning the search for improved social safety nets. Indeed, regulatory reform underpins safety nets by enhancing the creation of jobs, incomes and taxes.

10. Establishing the credibility of policies through transparent and even-handed implementation of business regulations is an important part of building effective and accountable public institutions and good governance for PSD. Providing good policy advice on investment climate policies has to be complemented by attention to the longer-term agenda of institution-building for PSD. In this context, corruption is a cause and symptom of underlying public sector dysfunction. To address this challenge, the Bank is increasingly focusing more of its efforts on building efficient and accountable public sector institution. It is working on several fronts: helping governments establish good internal rules to administer taxes, business regulations and other government services for business; using firm-level surveys to provide objective information on public sector performance and in turn giving voice to the private sector in setting priorities for reforms and monitoring the reform process; and enhancing competition for traditionally viewed public services through private provision and private participation in the provision of infrastructure services.

Infrastructure

11. Infrastructure needs are huge, and there have been funding difficulties for operations, maintenance and investment. Meeting the challenge of increasing access to quality infrastructure services will require sizable investments. Current estimates point to financing needs of about 7% of GDP for all developing countries—for both new investment and maintenance (O&M) expenditures—and as much as 9% of low-income countries' GDP. Comparing past actual investment and O&M rates (on average about 3.5 per cent of GDP in all developing countries) to projected requirements indicates the need to potentially double actual financing for infrastructure. This financing gap can, in part, be explained by historical constraints to both public and private funding for infrastructure. In recent decades, fiscal constraints slowed public infrastructure spending in many countries, for example, in India and in much of Latin America and Africa. The combination of inadequate fiscal resources and low user fees stalled system expansion and undermined quality of service. During the 1990s many countries tried to attract private investors. With the adoption of economic reforms, investment in infrastructure projects with private participation expanded rapidly from less than US$20 bn in 1990 to almost US$130bn by 1997, mostly in Latin America and East Asia, and then collapsed to a little above US$40 bn today. Private infrastructure developers and long term investors essentially withdrew as governments were unable to put in place sustainable policies that assured adequate and predictable returns, particularly in the politically contentious power and water sectors. In these sectors price levels prior to reform were just about 60 and 30 per cent respectively of cost in the average developing country. During this last decade, plagued by macro-economic shocks and strong currency fluctuations, many governments were unable to achieve and sustain cost-covering tariff levels. Furthermore, some of these governments defaulted on contractual obligations, increasing private investors' perception of risk and increasing the demand for risk mitigation support for long-term infrastructure funding.

12. A new balance between public and private sector roles is emerging for infrastructure financing and service provision. Public sector funding will remain central. Some 70 per cent of all infrastructure investments were publicly financed over the 1990s, with an additional 8 percent funded by official development aid, and calls on the public sector have increased as private investment slowed. At the same time, the scope for private participation in infrastructure remains substantial, by leveraging the mobilization of additional private capital per unit of available public sector resources. During the 1990s some 22 per cent of financing was private. Public-private partnerships that generate adequate cash flows for investors continue to flourish in sectors such as telecommunication, ports, airports, freight railways and natural gas pipelines, where user fees are imposed on large wholesale customers rather than retail customers. However, in sectors such as roads and water supply and sanitation, the public sector is likely to remain dominant.

13. A large variety of public-private partnerships are emerging to facilitate provision of infrastructure services. Infrastructure services are required at many levels: from small community services to multi-country/regional services. Small scale domestic providers of infrastructure services, such as small water and power systems have long existed to fulfill demand in rural or other areas where large providers have not been able to meet demand. These are being complemented by small services providers in newer areas, such as mobile telecommunications and airlines. For example, in one Southern province of Vietnam small scale providers have connected 65 per cent of the population to water pipelines over the last decade. Some six hundred power companies operate small systems in Cambodia. Similarly, infrastructure investments which cross sovereign borders, such as cross-country pipelines, dams, telecom and transport networks are becoming increasingly common, nearly all of which involve large scale private financing to complement public funding. These combinations of public and private operation and financing, at a scale which matches that of the need for infrastructure services, will remain a central part of the agenda.

WORLD BANK GROUP APPROACH TO INVESTMENT CLIMATE REFORM

14. The WBG is at the cutting edge of the investment climate reform agenda. The WBG is a leader in creating and applying innovative diagnostic tools for assessing the investment climate of our client countries and identifying the key factors driving growth and hence poverty reduction. More recently, it is expanding its efforts to bring best practice on solution design and lessons learned of political economy of reform to client country reform processes and to support client country efforts to adapt this knowledge to local conditions.

Diagnostics

15. Country studies. Binding constraints on firms vary significantly from country to country. Compelling analysis of these constraints is often helped by systematic and representative firm-level investment climate surveys in addition to traditional focus group approaches. Representative samples enhance the quality of analysis, and they greatly enhance the political legitimacy of the findings. Survey-based measurement is most powerful when it is used to identify constraints as well as when repeat surveys help assess progress and provide feedback to governments about the effectiveness of reforms. In recent years, the World Bank and the EBRD have been at the forefront of developing and using firm-level surveys for diagnostics and results measurement. The World Bank Group has launched firm-level investment climate surveys in 54 countries in the last three fiscal years, and at least another 15 surveys will be launched this year. Collaboration on common survey approaches is expanding between World Bank, EBRD and ADB, with discussion underway with other multilateral development institutions. Other important country diagnostics include the work by the joint IFC/Bank Foreign Investment Advisory Services (FIAS), which undertakes some 50-60 studies per fiscal year, and the Corporate Governance group, which prepares some 10 corporate governance assessments each year.

16. Global benchmarking and agenda-setting. Benchmarking of key features of the business environment is proving a powerful instrument to set agendas and to motivate reform efforts. The investment climate surveys are designed to yield comparable information across countries. The World Development Report for 2005 reviews results so far. The Bank-IFC *"Doing Business"* project has proven a particularly powerful global benchmarking tool. The 2004 report captured the procedures and the time and cost required to solve certain standard business problems for domestic small and medium sized companies across 133 countries, including OECD economies – to start-up companies, to deal with employees, to attract credit, to enforce basic contracts and to go through bankruptcy processes. The new edition *"Doing Business in 2005"* covers 145 countries and adds indicators on land titling and registration, inspection systems (for construction activity) and shareholder rights protection or corporate governance. The benchmarks have been used by IDA and the Millennium Challenge Account, as well as the European Union in support of the so-called Lisbon agenda to enhance country competitiveness. Work on *Doing Business in 2006* is underway.

Solution Design

17. Good practices. The Doing Business project is yielding systematic information on good practices for the design and implementation of laws and regulations. The indicators reflect what is "on the books" and thus allow easy identification of particularly useful solutions and ways to adapt them to different legal systems. A major effort is currently underway at the WBG, to systematically capture such good practice examples for use by governments. Work on good practice has progressed substantially in the area of micro-finance, where the Consultative Group to Assist the Poorest has developed an inventory of good practice and conducted a benchmarking exercise of the performance of aid agencies active in micro-finance. Similar work on good practice to assist SMEs is being assembled supported by an interagency working group, but requires substantial further progress. The IFC is currently focusing efforts on this work in its SME department.

18. Reform processes. As part of the World Development Report 2005 an effort has started to document case studies of reform experiences, and to identify political economy lessons from these experiences. The cases highlight options to design reform processes, to involve stakeholders, in particular to structure dialogue between the public and private sector, and to navigate the political challenges that may arise. The case studies of reform experiences together with good practice examples and the insights from diagnostic studies and benchmarking exercises are to form part of a new basic training course on investment climate reform that is currently being developed at the IFC/World Bank. The course is designed for staff who help governments support investment climate reform processes.

Implementation

19. WBG efforts are leading to successful reform outcomes. So far, Investment Climate Assessments are helping to shape some 30 new Bank lending operations and country programs spanning all Regions. In 20 developing countries and 12 IDA countries, *Doing Business in 2004* helped spur governments to cut either the time or cost of starting a business or both. Some 30 countries worldwide have instituted reforms motivated at least in part by the indicators of the report. *Doing Business in 2005* has just been released. And a new tracking system developed in FY04 found that on average 70 percent of FIAS policy recommendations were fully or partially implemented within three years that the recommendation was made.

20. Important issues of corporate social responsibility within the private sector are also at the forefront of the PSD implementation agenda. To help advance the corporate social responsibility agenda (CSR), the WBG is moving on several fronts: providing policy advice to governments on the public sector roles and instruments that can most effectively encourage CSR; facilitating CSR standard-setting through partnerships such as the one with the Global Alliance for Workers and Communities; and integrating CSR reporting in global supply chain analysis. This work complements IFC support to firms' sustainability strategies. In this regard, IFC is at the cutting edge in helping to set CSR standards with regard to issues such as stewardship of the environment and building best practice on public policy roles and instruments for enhancing CSR.

Results Measurement

21. A results measurement framework for both advisory and lending services is critical to ensure timely and effective support for investment climate reforms. As seen in the experiences of China, and more recently India, incremental reforms, placed within a programmatic framework can have tangible development impacts even before a comprehensive reform agenda is implemented. Thus for the many countries facing a broad and challenging reform agenda, a critical challenge is to build the political will and capacity to focus on selected binding constraints to business activity. In doing so, governments can create a credible commitment that, step-by-step, they will improve the business environment.

22. Experience shows that developing a rigorous and standardized basis to assess problems, identify priority areas, and subsequently monitor progress goes a long way in building public sector capacity to define and implement a country's investment climate reform agenda. Firm-level and expert-based surveys benchmarking key features of the business environment across countries are powerful tools to identify constraints as well as provide feedback to governments about the effectiveness of reforms. Firm-based surveys have the additional benefit of strengthening the voice of the private sector in policy dialogue.

23. Thus, to help build and sustain public buy-in for a programmatic approach to investment climate reform, the World Bank Group is placing greater emphasis on results measurement – for both advisory services and lending activities. Thus, FIAS is systematically monitoring implementation of recommendations for several years following an assignment. Indicators from Doing Business and from investment climate surveys also have found their way in the monitoring and evaluation efforts of the World Bank. For example, indicators from Doing Business are being used in Russia to monitor the level of regulatory burden on small business, and in Brazil to assess progress in a $505 million adjustment loan that includes components for improving business climate regulations and reducing logistics costs. In this context, support for the World Bank Group diagnostic work underway needs to continue and be further integrated into a broader results measurement program for lending activities related to PSD. In addition, sustainable results measurement efforts will need enhanced capacity building efforts in client governments.

Donor Coordination

24. Effective donor coordination, which includes some very productive partnerships with other donor agencies, is enabling the WBG to leverage its efforts and achieve greater development impact. Regular country-based co-ordination mechanisms applied to investment climate issues are paying off as other aid agencies are increasingly using the WBG diagnostics results and findings in their own programs and initiatives. For example, investment climate survey results are used by other agencies to develop reform programs, such as the DIFD programs for Mozambique and Kenya. Other partnerships include:: IDA collaboration with EBRD and the ADB on implementation and financing of investment climate surveys; co-financing FIAS work and PDFs (IFC contributes roughly 20 percent of facilities' operating costs, and multiple donors contribute the remainder); and the Norwegian Trust Fund window for activities related to private sector and infrastructure, which provides grant resources for World Bank Group activities aimed at mainstreaming investment climate, governance and infrastructure for the poor across the Bank and IFC.

WORLD BANK GROUP APPROACH TO INFRASTRUCTURE SERVICE PROVISION

25. The new WBG infrastructure agenda[2]. Against the backdrop of a decline in Bank infrastructure lending during the 1990s, recent declines in private investment, and the tremendous unmet demand, the WBG developed the Infrastructure Action Plan (discussed with the Board in July 2003 and the Development Committee in Sept. 2003). In the Action Plan, the WBG has committed to supporting infrastructure service delivery through a more balanced and pragmatic approach, including mobilizing funds from public and private sources. Significant progress has been made in advancing the infrastructure agenda. For example, the Bank has articulated and disseminated its approach to the respective roles of the public and private sectors in infrastructure service provision in a series of sector

[2] See accompanying paper "The World Bank Group's Infrastructure Business: Update on the Implementation of the Infrastructure Action Plan".

specific guidance notes in the power, water, transport, and telecommunications sectors. This has been translated into concrete projects responding to client demand; IBRD/IDA delivered an additional US $1 billion in infrastructure lending in FY04. It has also begun to rebuild the infrastructure knowledge base by ramping up country analytic work on infrastructure, developing a new analytical tool, the 'Recent Economic Developments in Infrastructure' (which was piloted in Colombia and Indonesia), investing in regional infrastructure studies together with partners, for example, in East Asia Pacific with the ADB and JBIC and investing in indicators for results measurement. The WBG has also begun to explore new approaches and instruments to enhance engagement at the sub-sovereign level—beginning with the creation of the Municipal Fund--and at the cross-country/regional level where there is a strong project pipeline, especially in Africa. In addition, the WBG is focusing on enhancing application of risk mitigation instruments, as well as assessing the potential for an increased role by small-scale services providers by, for example, conducting a global survey of such providers (through the global program PPIAF) and by including small scale providers in several output-based projects.

26. The balance between public and private sector roles. The WBG is pragmatically pursuing a variety of public-private partnerships to address funding and management issues. For example, three joint IDA-IFC projects are currently under preparation in the power sector in three African countries, each implying a different balance of public and private responsibilities. This allows private sector operating expertise to be merged with public funding where risks are such that private sector parties are unwilling to invest. Similarly, urban infrastructure concessions may be unbundled from rural ones, because different types of investors can be attracted in different locations with different risk characteristics. Also, more and more private providers from emerging markets are taking a lead role in the development of public-private partnerships schemes (for example, private companies from Brazil, South Africa, and India). In sectors with retail customers public-private partnerships schemes are innovating with structures where the private participation is coming via portfolio investments from local institutions, with operating capacities being provided by third parties (public or private) under simpler risk allocation mechanisms.

27. Expanding infrastructure finance, particularly at the sub-sovereign level. As the needs for infrastructure funding increase and available public sector resources cannot keep pace, the need to connect infrastructure development with private financial markets as a way to leverage and mobilize more capital becomes clear. New and improved risk mitigation products and applications, including in the area of currency and regulatory risk, will help to make this connection more effective. The WBG is already working on enhancing institutional capacity to enable financial markets to fund infrastructure development (that is, economic regulation, judicial reform, conflict resolution, etc.). However, to be able to further reduce the funding gap the WBG must increase its efforts to also work in the development of innovative risk mitigation products and applications that will foster private capital mobilization for infrastructure development. In addition, as an increasingly important part of infrastructure development takes place at the sub-sovereign level, the WBG must strengthen its support to those sub-sovereign entities responsible for infrastructure service provision. Helping sub-sovereign entities with the transition from relying on central government funding towards more market-based funding –by further strengthening of institutional capacity as well as providing risk mitigation--is a critical tool to mobilize additional capital for the provision of infrastructure services.

28. Fiscal space. Following a recent IMF Board discussion (April 2004), the IMF and the Bank have begun to explore, in a number of pilot countries, the scope for increasing the fiscal space for productive public investments, in particular in infrastructure. The approach focuses on three key areas—the targeting of the current fiscal balance, the treatment of public enterprises, and accounting for Public Private Partnerships—and recognizes that public expenditures in infrastructure assets can generate future returns and growth and should therefore not be unduly constrained. In several pilot countries, the Bank and the Fund are now working on how the principles can be put into practice, focusing on defining how to support public infrastructure investment, while maintaining fiscal responsibility and debt sustainability; exempting commercially run public enterprises from fiscal targets; and better measuring and managing public sector liabilities incurred in public-private partnerships.

29. Tariff and subsidy policy. The generation of sustainable adequate cash flows is crucial for infrastructure providers, be they public or private. This has been most difficult to achieve in the power and water sectors. Increasing revenues from users whilst achieving social objectives and avoiding adverse political reactions is a fundamental component of reform strategies. Underlying it all is the adequacy and predictability of cash flows for investors, be they public or private. Traditionally the Bank has had policies to require cost-covering user fees where practical in infrastructures sectors, for example, in power but not in roads. No amount of pragmatism can get around the need to set adequate tariff levels, even when they may incorporate cross-subsidy mechanisms or well-designed output-based subsidies to address the issues of affordability. Without adequate tariff levels the arguments to allow extra fiscal space are also weakened. Yet, insistence on politically difficult tariff reform may hamper efforts for productive client engagement. Guidance has been provided to staff on approaches to be followed when engaging in situations where service providers are not currently financially viable.

30. Output-Based Aid. The WBG is actively pursuing output-based aid (OBA) approaches, which are seen as potentially powerful schemes to enlist public-private partnerships to provide infrastructure services to poorer populations. These schemes feature targeted and performance-based payments provided by governments, combined with user fees, to establish adequate tariff levels while at the same time providing subsidies that are well targeted and performance based. Development of OBAs using WBG financial support to mitigate subsidy payment risks has the potential to: (i) increase access to private financial markets, (ii) improve performance of private providers, and (iii) expand WBG operations for the provision of infrastructure services. Over 30 projects are under preparation or implementation, for example, IDA and IFC pioneered a joint project in the electricity sector in Tajikistan. Scaling up of the OBA approach is a key component of the new infrastructure agenda.

DIRECTIONS FOR FURTHER WORK

1. Advisory Services and Capacity Building. World Bank Group support for our clients' investment climate reform agendas is most likely channeled through either advisory services in combination with policy-based lending, or through *stand-alone* advisory services and capacity building efforts. In the context of the clear need for scaling-up development assistance, we anticipate an increased use of advisory services supported by policy-based lending for those countries with fiscal or Balance of Payments (BoP) needs. However, as the benefits of advisory services are not dependent on a country's fiscal or BoP situation, we also expect increasing demand for free-standing advisory services, some of which will be done in collaboration with other donors. *Do Ministers agree that there is an important role for stand-alone World Bank Group advisory services that support the investment climate reform agenda?*

2. Results Measurement. To help build and sustain public buy-in for a programmatic approach to investment climate reform, the WBG is placing greater emphasis on results measurement – for both advisory services and lending activities. In this context, support for the World Bank Group diagnostic work underway, such as the Doing Business Project and Investment Climate Assessments, needs to continue and be complemented by an enhanced results monitoring program of reform progress in investment climate and infrastructure. Sustainable results measurement efforts will need capacity building in both the WBG and client governments. *Do Ministers agree that the results measurement agenda for investment climate reform needs to be further advanced and merits a sustained monitoring and evaluation effort?*

3. Political Economy of Infrastructure Reform and Fiscal Space. The Bank Group's business model emphasizes the need for finding pragmatic solutions along the entire spectrum of public and private sector provision of infrastructure services. This requires balancing the objectives of various stakeholders on key issues, such as ensuring sustainability of infrastructure service provision through cost recovery while meeting the needs of poor consumers. It also requires taking into account the issue of ensuring overall fiscal balance when committing public infrastructure expenditures, either through direct investments, through contributions to public private partnerships, or through the provision of targeted subsidies to poor consumers. *Do Ministers agree with the focus of the IMF-Bank work aimed at developing a common framework for ensuring fiscal balance and adequate risk management while maintaining fiscal flexibility for public infrastructure investment?*

World Bank Group's Infrastructure Business:

Update on the Implementation of the Infrastructure Action Plan

<u>September 15, 2004</u>

The purpose of this paper is to update the Development Committee on progress in implementing the Infrastructure Action Plan, which was reviewed by the Development Committee in September 2003. The paper complements the Development Committee Paper on the 'Elements of the Growth Agenda', which summarizes two key aspects of the growth pillar of development assistance, including the contribution of infrastructure. This paper focuses on highlighting specifically those key areas of progress, and challenges, in the Bank Group's support to infrastructure most relevant to the Development Committee. A detailed update on all elements of the Bank Group's infrastructure business was provided to the World Bank's Board of Directors in April, 2004.

Infrastructure and the Broader Development Agenda

1. Infrastructure activities supported by the Bank Group have evolved significantly over the past decades, and notably so in recent years. These activities are no longer merely about building physical assets, but are also about ensuring service delivery. As such, these activities support the provision of services—for water supply and sanitation, energy sources, and transport and communication modes—by increasingly focusing on quality of service, efficiency of delivery, and affordability to the ultimate beneficiaries. Infrastructure provision is no longer assumed to be the sole realm of the public sector nor that of the private sector, but increasingly about public-private partnerships for operation and financing.

2. In the broader development agenda, infrastructure has a central role and is now viewed as a major contributor to growth, poverty reduction and the achievement of the Millennium Development Goals (MDGs). Together with human capital and the policies and institutions which comprise the investment climate, infrastructure services have been demonstrated to be a critical factor in a country's growth. Indeed, an assessment of a number of studies on the correlation of infrastructure investment and a country's productivity or growth[1] suggests that the growth returns on investment in infrastructure are high, especially in the early stages of development when infrastructure is scarce and basic networks have not been completed. Another study suggests that if Africa had enjoyed growth rates in the physical stocks of telecom and power generation comparable to those observed in East Asia, its annual growth rate would have been about 1.3% higher during the 1980-90s.[2] A recent study of Latin America estimated that the lack of investment in infrastructure during the 1990s reduced long term growth by 1-3 percentage points.[3] Finally, recent analysis of the economic rates of return on infrastructure projects financed by the World Bank has also reconfirmed the important economic contribution of infrastructure: average economic rates of returns for infrastructure projects evaluated during the last three years were as high as 35%, and averaged a very respectable 20% in the preceding 40 years.

3. Significant anecdotal evidence, and a growing amount of empirical evidence, point to clear links between infrastructure services and many MDGs. Infrastructure services, in the form of water supply and sanitation, and to some extent housing and ICT, are explicitly covered as MDGs and thus are goals in and of themselves. In addition, infrastructure services make a significant contribution to other MDGs, such as health, education and gender. One survey of 49 studies[4] concludes that access to clean water reduces the probability of child mortality by 55%. The WHO reports that 88% of diarrheal diseases are due to unsafe water, sanitation and hygiene.[5] Transportation allows for easier access to and greater use of health care; indeed 11.5%

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[1] World Bank. (2004). Global Monitoring Report 2004. 94-95. Washington, DC: World Bank.

[2] Esfahani, Hadi and Maria Teresa Ramirez. (2003). "Institutions, Infrastructure, and Economic Growth." Journal of Development Economics. 70: 443-477.

[3] Calderon, Cesar, William Easterly and Luis Serven. (2003). "How did Latin American's Infrastructure Fare in the era of Macro-economic Crises?" The Limits of Stabilization: Infrastructure, Public Debts, and Growth in Latin America. Washington, DC: World Bank, and Palo Alto: Stanford University.

[4] Esrey, S.A., J.B. Potash, L. Roberts and C. Schiff. (1991). "Effects of Improved Water Supply and Sanitation on Ascariasis, Diarrhea, Drancunculiasis, Hookworm Infection, Schistosomiasis and Trachoma." *Bulletin of the World Health Organization.* 69(5): 609-621.

[5] WHO. (2002). World Health Report 2002: Reducing Risks, Promoting Healthy Life. Geneva: WHO.

of Africans report the unavailability or high cost of transport is the major barrier to obtaining health care.[6] Another study finds that a composite index of infrastructure (representing clean water, lack of indoor pollution, good sanitation and decent dwelling quality) has a strong and significant impact on child and infant mortality, with a 10% improvement in infrastructure resulting in a 1.2 - 2.0% reduction in under-5 mortality.[7] Empirical evidence is also surfacing on the contributions that specific infrastructure services (e.g., transport, telecom) make to MDGs and global goals in other areas such as education.

4. Potential growth and poverty reduction benefits can be achieved by providing greater access to quality infrastructure services. However, both access and quality are insufficient in most developing countries. Access to quality infrastructure services is particularly insufficient in rural areas. For example, only half of the population in low income countries is estimated to have access to water and sanitation services, whereas nearly three quarters of the population have access to water and sanitation in urban areas. Access to electricity is generally worse, with only 20% of the rural population in low income countries having access, compared to about 60% of the urban population. Meeting the gap of improving access to quality infrastructure services will require significant investments in new physical assets as well as in operations and maintenance (O&M). Current estimates point to financing needs of about 7% of GDP for all developing countries, for both new investment and O&M expenditures; these needs can be as high as 9% of GDP in low-income countries. Comparing past actual investment and O&M rates (on average about 3.5% of GDP in all developing countries) to projected requirements indicates the need to potentially double present levels of financing for infrastructure.

Re-orienting the Bank Group's Infrastructure Business

5. Juxtaposing the key role that infrastructure plays in development and poverty reduction against the large unmet needs for infrastructure services illustrates the key challenge for the infrastructure business of the Bank Group. Meeting the needs for infrastructure service provision requires mobilizing all sources of funds: domestic and foreign private investment, public domestic investment, and investments from the international financial institutions (IFIs) and bilateral donors. Traditionally, most investment in infrastructure has been publicly funded, constituting about 70% of current total spending. The private sector has contributed roughly 20%-25% while official development assistance finances only around 5%-10%. The Bank Group recognizes that the IFIs and bi-laterals are—relative to the magnitude of the challenge and overall financing requirements—only small players, but can play an important catalytic role in leveraging financing from multiple sources.

6. The *Infrastructure Action Plan* provides a basis for the Bank to strengthen this catalytic role by offering a more flexible, pragmatic, and balanced approach to infrastructure service provision. It has been developed based on the significant lessons learned over the past decades on both the public and private provision of infrastructure, as well as on the various forms of

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[6] Ross, Fiona, Richard Matzopoulos and Rozett Phillips. (1997). "The Role of Rural Electrification in Promoting Health in South Africa." EDRC Report Series. Cape Town: Energy and Development Research Center.
[7] Leipziger, Danny, Marianne Fay, Quentin Wodon and Tito Yepes. (2003). "Achieving the Millennium Development Goals – A Multi-Sectoral Approach Revisited." World Bank Policy Research Working Paper 3163. Washington, DC: World Bank.

public-private partnerships. As part of the Action Plan, the Bank Group has sent clear signals to staff, clients and partners about the centrality of infrastructure to the development agenda. And it has clarified its view, in light of the overall lessons learned, of the respective complementary roles of the public and private sectors in infrastructure by indicating a willingness to engage along the entire public-private spectrum for both infrastructure financing and service provision.

7. Based on lessons learned from the 1990s, the Bank has developed guidance notes on the respective roles of the private and public sectors—delineating options for Bank Group engagement at different stages of policy reform in each infrastructure sector—which illustrate the Bank Group's evolving business model.[8] In addition, the Bank Group has focused on implementing this guidance at the project and transaction level. The past year has yielded numerous examples of projects and transactions combining public and private involvement in financing and operation, blending the resources of IDA, IBRD, IFC, MIGA and donor grants utilizing a variety of instruments such as guarantees and output-based aid (OBA).

The Infrastructure Action Plan - Highlights of Progress Made

8. The Action Plan was endorsed by the Bank's Board in July 2003. It committed the Bank Group to respond to increased client demand for infrastructure, to rebuild the country level diagnostic work, and to strengthen the Bank Group's instruments and approaches. The implementation of the specific commitments (see Box 1) has been closely monitored by management and a detailed progress report on all items of the Action Plan was provided to the Bank's Board of Directors in April, 2004.[9]

Box 1: Progress under the Infrastructure Action Plan—An Overview

The Bank has responded to increased client demand by providing guidance on the respective role of the public and private sectors; increasing infrastructure lending and policy advice; and working with other development partners to tap synergies and develop common approaches. It has developed a template for analysis—the 'Recent Economic Developments in Infrastructure' (REDI)—and begun to rebuild country level diagnostic work and invest in infrastructure sector performance data to improve results management. The Bank has also improved its instruments and approaches through creating a cross-sectoral Infrastructure Economics and Finance department; strengthening the Bank's risk mitigation instruments; exploring multi-country and sub-sovereign engagement; and enhancing collaboration across the Bank Group.

Responding to client demand for infrastructure

9. The Bank Group has made significant progress on helping meet client demand and achieve outcomes of improved infrastructure service provision along all its key dimensions: access, efficiency, quality, and affordability. In that context, since the inception of the Action Plan in July 2003, the Bank has significantly strengthened its lending and ESW pipeline for both FY04 and FY05. The Bank delivered about 70 regionally-managed ESW products in FY04, and is expected to deliver roughly the same level in FY05. The Bank also committed close to $6.5 billion in new infrastructure lending in FY04, which constitutes an increase of $1.1 billion over

[8] World Bank. (2004). Public and Private Sector Roles in Water, Transport, Gas, Energy, and ICT. Washington, DC: World Bank.
[9] World Bank. (2004). Infrastructure Action Plan - Update. Washington, DC: World Bank.

FY03 (see Table 1 below). This is significantly greater than the commitments made in the Infrastructure Action Plan. IFC's total commitments in infrastructure for FY04 were $983 million, a significant increase over FY03 ($649 million) and FY02 ($722 million), largely driven by IFC's higher exposure on individual projects.[10] MIGA's guarantees for infrastructure in FY04 however, fell from $793 million in FY03 to $391 million, but it expects demand for guarantees to increase again in FY05. IBRD and IDA lending levels for FY05 are expected to remain strong, across all sectors. One sector that will receive special attention is renewable energy where the Bank has made an explicit commitment for a 20% p.a. growth for the next few years.[11]

Table 1. FY04 Infrastructure Projects and Commitments (in $millions)
(IBRD/IDA+GEF+Guarantees+Special Financing)

	# Projects		$ Commitments	
	FY03	FY04	FY03	FY04
SECTOR				
Energy and Mining	21.8	18.9	1,206	1,042
ICT	4.6	3.6	115	97
Transportation	20.4	31.1	2,731	3,819
Water and Sanitation	18.0	21.5	1,295	1,493
TOTAL	**64.8**	**75.1**	**5,346**	**6,451**
Urban Theme	**19.3**	**16.9**	**1,594**	**1,369**
REGION				
AFR	16.5	19.6	1,362	1,554
EAP	15.2	17.2	1,405	1,692
ECA	9.9	14.3	361	779
LCR	11.2	8.6	675	828
MNA	3.1	5.6	273	731
SAR	8.9	9.7	1,270	866
TOTAL	**64.8**	**75.1**	**5,346**	**6,451**
PRODUCT LINE				
IBRD	23.5	26.1	3,055	3,495
IDA	33.2	41.5	2,161	2,795
GEF	5.0	5.4	53	89
Guarantees	1.0	1.0	75	59
Special Financing	2.2	1.1	2	12
TOTAL	**64.8**	**75.1**	**5,346**	**6,451**
TOTAL				
World Bank Total	**261**	**267**	**18,909**	**20,493**
INF as % of WB Total	**25%**	**28%**	**28%**	**31%**

10. In FY04, there has been increasing representation of infrastructure in country programs, using some of the programming flexibility of existing CASs. In newer CASs, there appears to be a trend toward a more in-depth treatment of the growth agenda, and infrastructure's contribution to that. A review of a recent sample of 25 CASs illustrates that a majority placed prominence on the growth agenda in country programs and had a clear role for infrastructure services as part of that agenda.[12] Some recently approved CASs, such as the Indonesia CAS, show a very prominent treatment of infrastructure in terms of both analytical and operational work.

11. In addition, there have been an increasing number of operations where infrastructure is explicitly positioned within the context of multi-sectoral development outcomes. Illustrative is the issue of trade logistics to facilitate trade competitiveness, which contributes to stronger

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[10] IFC B-loans in infrastructure also witnessed strong growth, from $166m in 2003 to $321m in 2004.
[11] These targets are also related to the recent discussions on the Extractive Industries Review.
[12] See "Growth, Trade and Poverty Reduction" Draft IDA14 Discussion Paper (update).

growth; there are currently 15-20 trade and transport facilitation operations in the pipeline for the next three years. Similar is the Bank Group's commitment to increase its involvement in renewable energy and energy efficiency activities to serve broader country outcomes. The water supply and sanitation (WSS) agenda, where the Bank is playing a lead role as part of an international effort (see Box 2), is also multi-sectoral in its objectives and scope. Activities of this type are not always reflected in the infrastructure portfolio per se, but are major components of broader Bank efforts.

Box 2: Revitalizing Water Supply and Sanitation

The WSS sector, like other infrastructure sectors, is emphasizing the engagement of both public and private operators and financiers to improve WSS services across the developing world. Bringing in the private sector is critical, as the public sector alone will not be able to fill the gap to meet the MDGs and the needs of poor people. At the same time, the WSS sector faces enormous challenges in attracting private interest, stemming from issues related to cost recovery, affordability, institutional weaknesses and lack of access to financial markets. The Bank is supporting several initiatives to attract new operators, and is employing output-based aid (OBA) approaches to improve the performance of service providers and support targeted subsidies to the poor. It is expanding its lending for WSS operations—from $523 million in FY02 to $1.5 billion in FY04—and, as part of this, is actively working to enhance its sanitation portfolio. It has undertaken desk assessments in 21 countries to outline strategies to achieve the WSS MDGs, and has ramped up WSS ESW deliverables (from 19 in FY03 to 29 in FY05) which address key policy issues and suggest priority actions. It is actively involved in the international data collection effort to enable better monitoring of progress in the sector and is strengthening donor coordination—including guiding the strategic use of donor-funded global programs--to better align Bank efforts with those of its partners.

12. As demonstrated above, significant progress has been achieved in responding to the demand for increased Bank Group engagement in infrastructure. To maintain this momentum, the Bank needs to continue to work to address the issue of fiscal space for infrastructure investments. The current IMF/Bank country pilots underway will provide a basis for assessing the scope for finding greater flexibility for public investments, including for infrastructure, that will generate additional growth and thus tax revenues. In addition, the Bank must also continue to address the key constraints to supporting infrastructure activities in IBRD countries as identified in the Middle Income Country Task Force.[13] These include further reducing the cost of doing business with the Bank and improving the Bank Group's product mix and offering. The pilots on using country safeguards to ease the burden of engaging with the Bank while maintaining high environmental and social standards are a first step.

Investing in and rebuilding country knowledge

13. The Bank has launched an effort to deepen its knowledge, and measurement, of various dimensions of infrastructure service delivery (access, efficiency, quality, and affordability) and progress on sector reform. Improved knowledge and measurement is critically important for better understanding infrastructure's contributions to countries' economic development, for identifying priority investment needs, and for measuring infrastructure impact and results. The "Recent Economic Developments in Infrastructure" (REDI) template was developed to help meet these objectives by strengthening the Bank's country level diagnostic work in

[13] World Bank. (2004). Enhancing World Bank Support to Middle Income Countries.

infrastructure. The diagnostic work based on the REDI template provides a snapshot of the state of a country's infrastructure services and institutions, the associated investment needs, and an analysis of key sector policy issues. The Bank has delivered some 10 REDIs/REDI-like ESW in FY04 with full or partial sector diagnostics. Going forward, there will be an effort to mainstream the methodological approach of the REDIs into other Bank analytical work, such as Public Expenditure Reviews.

14. The Bank is also working to build common analytical and policy platforms with other MDBs and bi-laterals. As an example, the Bank, JBIC, and ADB have begun to work on a joint flagship study "Infrastructure Development in East Asia and the Pacific: The Way Forward", which will clarify policy and operational strategy issues for the next few years in the EAP region (synergies will also be explored with South Asia). The study, based on extensive regional consultations, is critical for ensuring coordinated approaches among the relevant MDBs and bi-laterals on the sector policy as well as the financing side. Similar studies are being considered for Latin America, and Europe and Central Asia. JBIC, GTZ, and AFD have also expressed interest in collaborating on specific country level diagnostics. These studies will contribute to a strengthening of the analytic and diagnostic understanding of the key infrastructure policy issues and provide a framework for enabling the appropriate, and coordinated, country level interventions by the MDBs and bi-laterals. The Bank has also convened and attended key conferences, which has served to further coordination among the MDBs and other development institutions, both across infrastructure sectors (e.g., IFI Roundtable on Infrastructure) and within a given sector (e.g., the World Summit on the Information Society and the Bonn Renewable Energies Conference). In this context, the Bank's cooperation with NEPAD is particularly important, given Africa's infrastructure needs.[14]

15. The Bank has also begun to develop a core set of infrastructure indicators for each sector, which will be critical for ensuring improved diagnostics, as well as better results measurement and management. Having baseline indicators will be important for demonstrating the impact of infrastructure interventions and for tracking progress over time. Indicators will be used for multiple purposes: MDG monitoring; IDA14 monitoring; corporate reporting (e.g., Global Monitoring); business reporting, for each sector and infrastructure more broadly; as input into results based CASs; improved project level outcome measurement; and as input into country-level analytical work (e.g., benchmarking data). Furthering this work program will require the collaboration of many different partners, both within and outside the Bank. To ensure the long-term sustainability of this monitoring and evaluation effort, it will be important to invest in building statistical capacity at the country level for the collection and usage of infrastructure sector data.

Strengthening the Bank Group's instruments and approaches

16. There is a tremendous need to leverage the amount of private capital per unit of available public resources, which is key to the effectiveness of the Bank's role in the infrastructure sectors. In that context, the Bank has created a new unit, the 'Infrastructure Economics and Finance' department (see Box 3), to strengthen the understanding of the practical implications of analytical infrastructure economics and to develop instruments and approaches for infrastructure

[14] AfDB is taking a lead in supporting NEPAD's infrastructure agenda.

finance. Major areas of development focus on increasing the Bank's ability to engage with sub-sovereign infrastructure-related entities and to develop instruments for risk mitigation; both of these are expected to enhance the Bank's ability to do business with Middle Income Countries.

Box 3: New Areas of Development in Infrastructure Economics and Finance	
Infrastructure Finance	Scaling up guarantee utilization and developing new risk mitigation applications.
Delivery of infrastructure services to the poor	Mainstreaming OBA approaches (standardizing procedures, increasing eligibility and sectors), and developing credit enhancement mechanisms to mitigate subsidy payment risks.
Increasing access of public entities, inc. sub-sovereign infrastructure utilities, to financial markets	Development of business plans, audited financial statements, credit ratings, etc., and providing financial support for the initial market based financings.
Infrastructure Economics	Fiscal space issues—together with the IMF—and assessment of infrastructure investment needs and finance sources.
Public Private Partnerships (PPPs)	Support to Bank clients in the development of PPP projects (transaction design and financing options, economic regulation and public sector risk management).

17. Infrastructure investments are often made at the sub-sovereign level, either at the state or municipal level. However, the Bank—which requires a sovereign counter-guarantee for sub-sovereign investments in IBRD countries—and the IFC—which focuses on the private sector—are not well set up to serve client needs at the sub-sovereign level. The main mechanism for the Bank today to engage at the sub-sovereign level is through on-lending arrangements to states and municipalities. The Bank is attempting to maximize the use of these arrangements, especially in the water sector, by using innovative approaches to support sub-sovereign investments. Several projects (e.g., in Ethiopia and Colombia) involve sovereign lending which ties infrastructure investments to demonstrated reforms and institutional strengthening at local levels. In other cases (Philippines), national governments have on-lent funds to local authorities to finance design-build-lease contracts that leverage private financing. Such arrangements are however, limited in that they allow no direct engagement in sub-sovereign markets or with local authorities.

18. Demand for financing is high in sectors where service provision tends to be decentralized and community-based (i.e., water and sewage, urban transport, etc.). However, low credit worthiness and lack of corporate governance in many of these sub-sovereign entities present a major hurdle for lending without central government support. But lending with sovereign guarantees limits the scope of reach to these entities, and hinders the required capacity building to enable independent access financial markets, which is key to leveraging the needed private capital to close the infrastructure financing gap. The challenges of financing sub-sovereign entities provide major impediments to the Bank Group's ability to scale up engagement in decentralized infrastructure sectors.[15]

[15] This issue has been highlighted in the World Panel on Financing Water Infrastructure, chaired by Michel Camdessus, which released its report "Financing Water for All" in March 2003. The Bank Group outlined its follow-up actions in response to the Panel's recommendations in September 2003 and reported to the Bank's Board of Directors on progress made in implementing follow-up actions in April 2003 (see World Bank. (2004). Infrastructure Action Plan – Update (Annex 2). Washington, DC: World Bank).

19. To gain a better understanding of the opportunities for more direct interventions in the sub-sovereign market segment, the Bank Group established the Municipal Fund. The Municipal Fund has successfully closed two transactions (in Mexico and South Africa), and has a pipeline of ten additional pilot transactions. Other initiatives have also been developed with donors, such as Guarantco (a local currency guarantee facility to support infrastructure financing by domestic financial institutions and municipalities). In addition, the Bank is working on the development of a facility to increase the number of public entities, including sub-sovereign utilities, that can access private financial markets without central government support. The Facility will aim at helping sub-national governments in economic reform, capacity development and fiscal independence. As part of this effort, and given the importance of sub-sovereign infrastructure development within the Infrastructure Action Plan, the Bank will report to the Board within this fiscal year on the challenges of sub-sovereign financing and a proposal for a course of action.

20. The Bank is making significant progress in its ability to support private sector investment in infrastructure. It has eased some internal constraints on the use of guarantees by introducing new accounting in the CAS envelope which, in effect, counts only 25% of the guarantee's face value against the IDA allocation or IBRD lending ceiling to a country. This is expected to enable a scaling-up of the use of Bank guarantees. Other risk mitigation applications are being considered in the areas of regulatory risk (to support privatization transactions) and in the development of local currency debt instruments.

21. In the area of currency risk, where there has been strong demand for support by investors, various schemes—such as the Foreign Exchange Liquidity Facility—have been recently considered by senior management but not pursued, due to concerns related with risk management under the proposed Bank guarantee structure. The lack of depth in currency markets in most developing economies provides a real challenge to develop products to mitigate currency risk. However, aware of the impact of foreign exchange risk—especially in water infrastructure financing—the Bank is working on the development of alternative support mechanisms that could partially address some of the investors' concerns stemming from currency risks.

22. The Bank is actively pursuing the use of OBA approaches as a way to improve service delivery to poor communities by attracting public-private partnerships under performance based arrangements. Currently over 30 such projects are under preparation or implementation, and are aimed at expanding services to low income consumers, or to protect the poor from increases in prices required to reach financial viability. Opportunities exist to offer Bank Group solutions via OBA; as an example, IDA and IFC pioneered a joint OBA project in Tajikistan. The Bank is also managing a trust fund, the Global Partnership for Output-Based Aid (GPOBA), which supports the design and evaluation of OBA schemes and the dissemination of knowledge on OBA. A new window to provide direct funding for the subsidy component of OBA transactions via GPOBA grants is currently under preparation. This new window is expected to encourage an expansion of OBA approaches by allowing the testing of subsidy payment schemes with secured funding during a pilot phase.

23. There has also been an increased focus on expanding Bank support at the regional/cross-country level to complement the Bank's support traditionally channeled at the country level. Addressing the lack of integration of regional infrastructure networks across national boundaries

can enable infrastructure to make its full contribution to development. Cross-country roads, pipelines, dams, ICT and other technologies which facilitate the flow of goods, water, and power are obvious candidates. In the Africa Region, regional projects have become an important business line in recent years: four operations are under execution, representing total commitments of $415m and another six are in the pipeline representing approximately $600m in commitments. The ECA region has also produced good examples of multi-country projects. Going forward, there is a need to explore the potential for such activities in other regions.

24. The Bank Group has made significant progress in expanding its approaches and instruments, and much of this activity has deepened collaboration between the IFC, MIGA, and the Bank. Blending IDA, IFC and bilateral resources, such as in the Pamir Power Project in Tajikistan, or the combination of IBRD and MIGA guarantees with IFC equity, as in the South Africa Regional Gas Project[16], are particularly promising approaches. However, given the strong financial leverage impact of integrated Bank Group assistance, the Bank Group needs to find ways to scale-up this form of assistance by offering clients a more integrated package of services from the World Bank Group.

Key Challenges Ahead

25. Progress has been made on many fronts, most importantly, translating the mandate of the Board and senior management to better respond to client demand by increasing infrastructure engagement through lending and policy advice. However, after nearly a decade of declining Bank engagement in infrastructure, turning around the infrastructure business and achieving results on the ground will require a multi-year effort.

26. Many important challenges remain to be addressed. Experience needs to be gained and lessons disseminated to fine-tune implementation arrangements for public-private partnerships, including expanding infrastructure financing opportunities, and implementing pragmatic solutions to tariff adjustments and subsidy needs. Continued attention will need to be paid to fiscal space issues. Efforts will need to continue to further develop and apply instruments for risk mitigation, and to assist public entities, including at the sub-sovereign level, to access private financial markets without central government support. These efforts will be particularly important to improve the menu of options to serve middle income countries. The utilization of new instruments with an emerging track record, such as OBA, will be expanded and increasingly focused on providing infrastructure services to poor households.

27. On the business side, efforts will be increased to assure quality during the rapid scaling up of lending, including ensuring that there are adequate resources (both human and financial) to deliver high quality products and services. The IDA-14 replenishment will be key to this challenge, to ease the existing constraints of the present IDA allocation in meeting the demands for infrastructure from IDA clients. Increased efforts will be needed to ensure smooth coordination across the Bank Group to provide an integrated package of services to clients. Finally, there is the challenge that, while the Bank Group has strong support for increased infrastructure engagement from its borrowers and shareholders, the private sector and even many

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[16] This project leveraged about US$ 1 billion in private sector investment , about one third of total private sector investment in Africa.

client country NGOs, some infrastructure projects may become the target of advocacy NGOs. Therefore the Bank Group, and the development community as a whole, needs to continue to proactively demonstrate and strategically communicate the growth and poverty reduction benefits of well designed and implemented infrastructure programs.

Issues for Discussion at the Development Committee

1. IDA-14 Replenishment. The demand for increased access to quality infrastructure services is particularly high in low-income countries and demand for IDA-supported infrastructure projects has exceeded supply throughout the duration of IDA 13. Private sector activity in IDA countries has traditionally been low, although there have been some successes in attracting private sector interest if coupled with IDA support. New IDA availability will provide the opportunity to use new approaches for delivery of basic services to poor communities via public and private sector providers. *Do Ministers agree that additional support for infrastructure is an important priority in the ongoing IDA replenishment discussions?*

2. WBG Engagement at the Sub-Sovereign Level. Much of infrastructure is provided at the sub-sovereign level. Bank support for this has traditionally been through on-lending arrangements from national governments or through the recent Bank/IFC Municipal Fund pilot. Still, there remains a large unmet demand for additional infrastructure financing at the sub-sovereign level, yet most sub-sovereign entities cannot access financial markets today without central government backing. These entities are in need of institutional support to access adequate sources of long-term finance. *Do Minister's agree that the Bank Group should explore additional options for helping meet infrastructure demand at the sub-sovereign level?*

3. World Bank Group Collaboration. IFC, MIGA, and IDA/IBRD have improved their collaboration significantly over recent years—as evidenced by a number of high impact and innovative projects. Despite this progress, World Bank Group collaboration remains at times ad-hoc and limited to only a select number of transactions. *Do Ministers agree that the World Bank Group needs to place additional emphasis on ensuring that a seamless product offering is provided to its clients along the entire spectrum of the public and private sector?*