Financing Urban and Local Development: the **Missing Link** in Sustainable Development Finance

A briefing on the position of the role of local and sub-national governments in the deliberations related to the Financing for Development Conference.

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The Global Taskforce of Local and Regional Governments facilitated by UCLG gathers over 30 networks that are active internationally. Please visit http://www.gtf2016.org/ or write to globaltaskforce@uclg.org

The international community is devoting great energy to the **critical task of financing sustainable development post-2015** and looking towards the 3rd Conference on Financing for Development (FfD3) in Addis Ababa. A huge volume of public and private investment is needed to reduce poverty, cope with climate change and promote prosperity in the coming decades. Many countries face a **sizable infrastructure gap and anticipate new demands from population growth and continued urbanization** (more than 2.5 billion urban dwellers by 2050, mostly in developing countries). Estimated requirements vary but are as high as $90 trillion. The vast demand for productive infrastructure investment coincides with unprecedented global liquidity in search of investment opportunities.

This paper aims first to deepen the advocacy work in favor of acknowledging local governments' core role in the development agenda and for the attainment of the Sustainable Development Goals, and then to analyze the various financial mechanisms to improve for LRGs to be able to fulfill this role.

Position Paper

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1. Introduction

1.1 Local governments in the FfD Agenda

The **High Level Panel on the Post 2015 agenda** argued that the battle for sustainable development will be lost or won in cities and the **UN SG Synthesis Report** stated that “many of the investments to achieve sustainable development goals will take place at the subnational level and be led by local authorities”.

The **Zero Draft for the Addis Ababa Accord**, released in March, recognizes that "... in more and more countries, responsibilities for revenues, expenditures and investments in sustainable development are being devolved to the sub-national level and municipalities, which often lack adequate technical capacity, financing and support." To support local authorities, it commits: "...to develop mechanisms to assist them, including to strengthen capacity, particularly in areas of infrastructure project development, local taxation, sectorial finance and debt issuance and management, including access to domestic bond markets..."

It also proposes "... implementing resilient infrastructure and climate-friendly policies and investments..." and indicates the need to support “national and local capacity for prevention and mitigation of external shocks and risk management” [para 36].

Yet in the course of the numerous FfD deliberations there has generally been **insufficient consideration of the potentially indispensable role of local and regional governments (LRGs) in building sustainable cities and territories** and inadequate focus on the resources and capacities LRGs will require to be able to maximize their contribution to development in the critical years ahead.

Although this text represents a step forward in the FfD3 debate to acknowledging the importance of subnational governments, it still does not go far enough **to recognize the key developmental role of LRGs, particularly in urban areas.** In addition, there is insufficient attention to critical aspects of LRG reforms and the considerable diversity of LRGs across and within countries, which will necessitate varied policy responses.

The upcoming FfD3 Conference provides a unique opportunity not only to advance thinking on **how to facilitate the mobilization of funding necessary to promote sustainable local development**, but also to deepen global understanding of **how to unlock the developmental potential of local/urban areas** and the bodies that govern them.

- What **specific roles** can LRGs play in financing and delivering the SDGs?
- How can LRGs **mobilize part of the wealth** produced within their jurisdiction (domestic resources) to finance and support development?
- What **steps are necessary** to enable LRGs to play these roles?
- How can **national and global actors improve LRG creditworthiness and access** to long-term finance and strengthen their capacities to deliver sustainable services?

1.2 The developmental role of Local and Regional Governments (LRGs)

A number of factors suggest that LRGs are an integral actor in sustainable development.

- **First,** most advanced countries rely on LRGs to take responsibility for major public functions and investments. LRGs account for about a third of total government spending and up to 70% of public investment in OECD countries.

  Decentralization has been less prominent, more uneven and more recent in low and middle-income countries, but there is **evidence that if well structured and supported**, **LRGs can contribute substantially to development outcomes, meeting not only local needs but also supporting national objectives and, particularly, to achieve the SDGs**.[1] For this to occur, however, **national governments must adopt adequate frameworks to empower, resource and support LRGs**, as explained more fully below.

- **Second,** many countries face considerable backlogs of infrastructure demands, and anticipate **new ones with population growth and continued urbanization**.[2] Addressing the challenges of urbanization and inadequate infrastructure will require huge investments in the coming decades, often in sectors for which LRGs do or should have responsibility. The demand will be greatest in developing countries, but OECD countries must also invest to deal with, among other needs, their deteriorating infrastructure and aging populations.

- **Third,** the SDG and FfD initiatives are framed from a very broad perspective and around individual goals. **The SDGs, however, must be situated and acted on in an integrated way in specific territorial jurisdictions, as acknowledged in the 11th SDG goal**.

  LRGs are in principle better placed to think more holistically about development relative to international or national bodies. The key role of specialized, higher level actors--global agencies or national ministries that focus on education, environment, health, water, etc.--is undisputed, but they cannot fully appreciate the integrated context-specific nature of sustainable development on the ground and are not well placed to respond to the priority needs of people living in specific places and deal with other key concerns, such as gender.

- **Fourth,** the world faces growing resource challenges--global warming, energy shortages, health crises, food security, etc. Dealing with them is a core task of or affects attainment of many SDGs, particularly in expanding urban areas. LRGs are in a strong position to respond to these challenges, through for example, climate adaptation and green growth strategies. Many **urban governments could also play a significant role in addressing the lingering effects of the 2008 global financial crisis and future challenges on that front.**

1.3 The National and Global importance of local /urban territories

Urban areas have long been engines of economic growth.[3] Urbanization was an important phenomenon in the development of OECD countries, and demographic transitions in developing countries have pushed rapid urban population growth. This trend is reinforced by the changes in agricultural technology, with the agricultural share of the labor force in low and middle income countries expected to drop to 10 percent in the coming decades. In industrial, commercial and service sectors, urban localization economies enable firms to specialize and realize scale advantages, supporting growth. More generally, cities are known to be incubators of innovation that stimulate economic and social development.

Approximately half of the world's people already live in urban areas.[4] As the global population grows from about 7 to more than 9 billion by 2050, most are expected to be absorbed by urban areas in many countries. **Urbanization levels are projected to approach 85% in industrialized and 64% in developing countries**. The number of megacities (>10 million population) is expected to increase to 27 in 2025 (21 in developing countries) and they are projected to account for nearly 10% of the world's urban population An additional 48 cities are anticipated to have between 5 and 10 million residents, three fourths of them in developing countries.
Intermediate/secondary cities will also grow in significance, and networks among cities will become increasingly critical for development.

Much of the focus in territorial development is on urban areas because of their economic, political and social significance, but **all people live in a locality**. Even if smaller jurisdictions

[1] The evidence is reviewed in Local Development International (2013).
[2] See UCLG (2010, 2014), Ingram, Liu and Brandt (2013) and UN (2014).
[3] A useful historical and forward looking review is provided in Yusuf (2013).
[4] See UNDESA (2014).

are not as important to the national economy as cities, they require action by governments and their partners to deliver basic services and to nurture economic and human development. LRGs are increasingly recognized to be important actors on this front, including in the mobilization of resources.

1.4 The constrained fiscal role of Local and Regional Governments

The role that LRGs actually play is quite mixed, often primarily due to very uneven empowerment and sources of financing made available to them by central governments. Data are limited and averages mask much variation, but data from selected countries presented in Table 1 (UCLG 2010) provide a general sense of the landscape.

Local governments are relatively empowered in much of Europe, North America, and parts of East Asia and the Pacific (Korea, Japan, Australia, and New Zealand). In the Middle East and West Asia, most LRGs are effectively deconcentrated units of the central government with limited autonomy.
Even with recent democratization and decentralization reforms in many countries in Africa, South/Southeast Asia and Latin America, LRGs face constraints largely imposed by higher levels, most strikingly on the revenue side.

Table 1: The Comparative Fiscal Role of Local Government (Means)

Regions	Local Government Shares of Total Public Sector	
	Revenues	Expenditures
North America	17.8	26.8
South Asia	1.5	16.0
East Asia	20.0	40.0
Southeast Asia	5.3	15.5
Europe (2008)	13.0	23.9
Middle East & Western Asia	N.A.	4.6
Eurasia	N.A.	26.5
Latin America	4.0	11.1
Africa	3.2	7.9

Source: GOLD II report, UCLG (2010).

1.5 General Requirements for Effective Local and Regional Governments

If LRGs are to meet growing demands to be key players in the SDGs and how they are financed, **several critical requirements must be met**.

- ***First, LRGs must be empowered to act more autonomously.***

This means that national governments must be willing to share adequate power through suitably robust decentralization frameworks.

There are two aspects to this empowerment. The first is the need to **assign specific functions to LRGs along with structures, systems, and resources that support their execution**.[5] The most robust form of decentralization is devolution, under which elected and empowered LRGs are directly accountable to citizens. LRG proximity to citizens gives the latter more influence over local officials, promotes productive competition among LRGs, and can alleviate corruption through improved transparency and accountability. For this to occur, however, there must be sufficiently clear assignment of functions so that both the central government and citizens **know what to hold LRGs accountable for**.[6]

An emerging and more potent view of decentralization focuses on vesting autonomous LRGs not only with centrally assigned powers and functions, but also with **a general mandate to provide for the overall development of their territorial jurisdictions and the welfare of their constituents**.[7] This is more robust form of empowerment gives LRGs greater authority and incentives to pursue customized integrated development strategies.

- ***Second, LRGs need sufficient resources to carry out their functions as per the discussion above.***[8]

[5] Selected recent overviews include Boex and Yilmaz (2010), Eaton, Connerley and Smoke (2010), Martinez-Vazquez and Vaillancourt (2011) and Bahl, Linn and Wetzel (2013).
[6] McClure and Martinez-Vazquez (2004) provide a detailed review of conventional wisdom.
[7] See Council of Europe (1985), UN Habitat (2011), Commonwealth Local Government Forum (2013) and Romeo (2013) for elaborations on this perspective.
[8] Bahl and Bird (2008) and Smoke (2014) critically review local revenue generation principles and empirical literature.

Central governments have inherent revenue advantages and must maintain overall macro-fiscal integrity, so they require some control over the total volume and use of public resources. Thus, **shared taxes and transfers are always vital in a LRG revenue system**, but how they are defined and implemented will profoundly affect LRGs' ability and incentives to deliver services and raise revenues. **Payment of local revenues by residents and businesses is critical**--willingness to pay indicates demand for and satisfaction with services and general trust in LRGs. A **common reluctance among central governments to allow strong LRG revenue powers** means leads to a greater than necessary role for transfers, which often suffer from design and implementation flaws already noted above.

- ***Third, LRGs need to be transparent and accountable.***[9]

The focus in devolved systems is on **downward accountability**, especially through elections and other means that allow citizens regular and meaningful interaction with/influence on LRGs, such as participatory planning/ budgeting, citizen report cards, complaint and appeals boards, etc. Transparency and access to information on LRGs processes and decisions--through managerial mechanisms (budgeting, financial management, audit, etc.) and freedom of information laws--are essential for downward accountability and help to reduce opportunities for corruption. **The lack of consistent and reliable data significantly hinders accountability.**

Upward accountability also plays a fundamental role. Mechanisms for upward reporting, including financial and physical reports (general/sectoral), performance assessments, and external audits, promote consistency and transparency--they provide valuable information to citizens, other LRGs and the central government. Central agencies with broad mandates (finance, planning, civil service) develop policies and regulate/monitor LRG compliance with, for example investment planning, public financial management (including procurement), revenue collection, and human resource management systems. Sectoral ministries (health, education, etc.) develop and monitor service standards and manage conditional transfers. **Such regulatory/oversight functions are essential but can hinder LRG performance if they are too stringent or inconsistently/arbitrarily applied.**

[9] See reviews in Bardhan and Mookherjee (2006), Shah (2006), Cheema and Rondinelli (2007), Boex and Yilmaz (2010), Yilmaz et. al. (2010), Agrawal and Ribot (2012), Faguet (2014).

An often- neglected element of LRG accountability critical for good performance is **horizontal accountability**—between elected LRG government councils and LRG staff who execute local budgets. A clear division of roles is needed--elected councilors set development policies and monitor staff members who implement them. It is not uncommon in newly decentralizing countries for staff transferred from the center to look upward for direction, potentially undermining the authority of leaving LRGs councils. Horizontal accountability is also complicated where separate legal entities have been set up to deliver local services, such that elected representatives are accountable to their electorates for service delivery while the company management is responsible for financial requirements.

In sum, accountability relationships are essential for effective local service delivery, but there is no single best approach. **The core challenge is to set an appropriate balance between upward and downward accountability, which can evolve as LRGs grow stronger and are better able to manage functions more independently.**

- ***Fourth, LRGs must have capacity to function effectively and to act developmentally.***[10]

The importance of adequate capacity is widely accepted and capacity building is typically provided for LRGs. Such efforts, however, tend to focus primarily on technical and managerial staff and the mechanics of new systems and procedures. More limited attention is given to the capacity of other actors--those at higher levels of government whose roles change when LRGs are empowered and the constituents of LRGs who play a central role in holding local governments accountable for meeting their needs. Moreover, financial advisory support for LRGs to develop viable planning and financing mechanisms for infrastructure service provision is insufficiently provided or inadequately structured.

Capacity building requires a broad range of steps and adequate information to improve the nature and quality of interactions among actors—levels of government and subnational actors (elected officials, government staff and citizens)—whose collaboration is essential for accountable and effective service delivery and strategic development. In addition, capacity building often consists primarily of conventional classroom training (rather than on the job/on-site support) that often insufficiently prepares recipients for using new skills on the ground to better support development.

[10] See, for example Green (2005) and UNDESA (2005).

2. Enhancing the critical fiscal role of Local and Regional Governments

If LRGs are to play their rightful role in meeting the SDGs, it is important to **adopt appropriate fiscal reforms and financial instruments.**[11] Urban governments in certain countries have strong fiscal bases and are creditworthy. Many other LRGs, however, have weaker fiscal bases and creditworthiness and limited access to long-term funding.

Before deciding which finance instruments should be used by LRGs, it is important to document and analyze the current fiscal situation in a particular country.

Weak revenue generation can result from multiple factors in various combinations, such as:

- Central government restrictions on local revenue powers
- Limited local capacity to collect revenue and/or deliver services
- Local revenue generation disincentives from poorly designed fiscal transfer programs
- Low political credibility/accountability to local residents/businesses, weakening revenue compliance.

Thus, the mix of financial instruments must be carefully tailored to country context. As outlined below, fiscal reforms will in many cases need to be phased in and accompanied by other institutional reforms and capacity building initiatives if they are to be successful.

2.1 Own source revenues and routine intergovernmental transfers

The dual foundation of a successful LRG fiscal system is the regular revenues raised by LRGs and the national revenues shared with them. As noted above, revenue performance is often weak (Table 1), especially in developing countries. Property taxes as a percentage of GDP, for example, account for over two percent of GDP in OECD countries, but only 0.5 percent in developing countries. Property tax is difficult to manage without proper land registers, where informal construction is widespread, and where administrative capacities are weak. There are, however, mechanisms that have been used to reduce these challenges in motivated LRGs, such as mass appraisal, refined legal frameworks for defining liability, and reform of collection and enforcement mechanisms.

Central governments have inherent advantages in generating revenues and LRGs have inherent advantages in providing certain key services, invariably necessitating intergovernmental transfers. There are substantial opportunities through reforms covered in the FfD documentation to broaden and improve the bases and administration of national sources that can be shared with LRGs, including dealing with illicit flows and tax evasion. Some measures for improved LRG administration and governance are outlined later.

Despite the central government edge in revenue generation, **LRGs must be able to raise an adequate share of the resources they spend**. This **reduces demands on central budgets and creates a fiscal linkage between benefits of local services and the costs** of providing them. The proceeds of locally generated revenues are also essential for **making payments on loans required to finance capital investments.**

[11] Recent overviews include UCLG (2010), Bird and Slack (2013), and Martinez Vazquez (2014).

Own Source Revenues

Although some LRG control of revenues is essential, **revenues derived locally need not be from purely local taxes, and LRGs need not directly collect all revenues**. A range of domestic instruments are available (Table 2), three of which involve greater LRG control.

- **Own-source revenues** involve some local control over the revenue base and/or rate and are often primarily administered by LRGs.[12]

- **Centrally assisted revenues** are those for which LRGs **request central (or higher level, e.g. state/provincial) government assistance in collecting certain local taxes on their behalf**, e.g. local taxes levied on businesses that a higher-level government collects its own taxes from.

- **Surcharges** allow LRGs to add a charge ("piggyback") on higher-level taxes (e.g., VAT, sales or excise taxes), providing them with some revenue autonomy while tapping the benefits of more centralized administration.

All of these forms of revenue are based on territorial revenue bases. This means that they tend to favor wealthier LRGs and thus may require central government attention to the resulting fiscal inequalities across subnational jurisdictions.

Common and generally accepted local revenue sources include property taxation, fees and charges, licenses, limited types of business tax, and sometimes at intermediate or urban levels, other sources, such as motor vehicle revenues and business or sales taxes. All of these are often underutilized, especially in developing countries, but some countries make greater efforts, such as Indonesia and South Africa with the property tax. **Piggybacking on national taxes** is often recommended, but practiced mostly in a few federal or larger countries and for intermediate level LRGs. These sources are not particularly controversial in most cases, although the details of how they are structured and managed may be.[13]

More controversy surrounds certain other potential subnational revenues, such as VAT, some forms of business taxation (including business value taxes), **and natural resource taxation**. Commonly expressed concerns include tax competition, the complexities of administration, and interregional equity considerations (due to the common concentration of business activity and natural resources). A number of countries, such as Brazil, India and Indonesia, successfully use such sources, but they are not widespread.

Table 2: Types of Domestic Public Sector Revenue Available to Local Governments

	Choice of base	Choice of rate	Managed by	Flows based on	LG Autonomy/Examples
Own source	Local	Local	Local	Local Tax Base	LGs have considerable control, e.g. property tax
Centrally assisted	Local	Local	Local/ Center	Local tax base	LG tax collected or assisted by higher level government at LG request
Surcharged	Center	Local	Center	Local tax base	LGs permitted to add % to higher level tax, e.g. sales or income tax
Tax sharing	Center	Center	Center	Local base or formula on Central base	LG receives % of higher level tax set by taxing level e.g. VAT, natural resource taxes…
Grant	Center	Center	Center	Criteria or formula on Central base	Many types of unconditional or conditional transfers share CG tax bases with SN governments

[12] Bird (2006), Bahl and Bird (2008), Smoke (2008), Bird (2011), McCluskey and Franzen (2013) and Martinez-Vazquez (2013) review key literature on local/urban revenues in more detail.

[13] This is a VAT levied on the basis of income (production, origin) rather than consumption (destination), which is discussed by Bird (2005, 2006).

One of the most potentially powerful but underutilized sources of LRG revenue is capture of the increment in land value generated by infrastructure projects (local roads, sewerage, transit water, etc.)[14] There are multiple ways of achieving this goal, including betterment levies, tax increment financing, special assessments, and land readjustment, among others (Table 3). Recent experiences suggest that the land value contribution could represent an important share of public investment made in the context of development or urban restructuring projects. Brazil, China, Colombia, India and several OECD countries, among others, have effectively used such sources in different forms and to varying degrees.

Since public infrastructure investment is not the only factor that affects land value, there are longstanding debates about exactly **how to appropriately tap this value to recoup the costs of infrastructure investment**, but there is broad consensus that that this is a legitimate and potentially productive source of revenue for LRGs.

For this potential to be realized, however, there must be a certain level of development of property rights and land valuation systems, and LRGs must have sufficient capacity and political credibility to extract revenues based on increases in land value. In some cases, there can be immediate benefit, while in others these conditions will have to be built over time. In some cases, there can be immediate benefit, while in others these conditions will have to be built over time.

On balance, **there is broad agreement that many central governments, especially in developing countries, err on the conservative side and decentralize fewer revenue sources than would be justified by economic principles and LRG needs.** [15] There is clearly much room for greater LRG revenue empowerment, but tailored to each country.

Table 3: Selected Land Value Capture Instruments

Revenue Instrument	Basic Description
Betterment Levy and Special Assessments	Lump-sum assessments levied by LRGs on developers or homeowners to finance public service improvements that increase property values
Tax Increment Financing	Surtax on properties to be redeveloped and financed from LRG bonds against expected property tax increases
Land Readjustment	Pooling of land with a share sold to raise resources to partially fund infrastructure development
Land Sale or Lease	LRGs sell developers land or development rights where land value has increased from public action; can be in the form of an upfront payment, leasehold charge or annual land rent

Intergovernmental transfers

Virtually all countries--industrialized and developing--use intergovernmental transfers because of the **gap between appropriate expenditure and appropriate revenue decentralization.**[16] They can also **enhance LRG autonomy and meet national objectives by offsetting fiscal capacity differences among LRGs and encouraging expenditure on key local services** that generate benefits beyond recipient jurisdictions, meet basic needs of LRG residents, and stimulate development expenditures. Many transfer systems are intended to meet these objectives to varying degrees. Large cities tend to be more revenue independent than other LRGs, but transfers are still vital even for metropolitan areas in many countries.

One of the most recommended features of transfer design from the perspective of local governments is for the central government to identify a **stable (rule-based) transfer pool** rather than make ad hoc annual budget decisions on the volume of resources going to LRG transfers.

[14] See, for example, Peterson (2009), Ingram and Hong (2012), Walters (2012), World Economic Forum (2014), Suzuki et. al. (2015).

[15] See United Cities and Local Governments (2010), especially the concluding chapter. There is clearly much

[16] Reviews of transfers include: Bird and Smart (2002), Schroeder and Smoke (2003), Boadway and Shah (2007), Shah (2013).

This allows LRGs to better plan for service delivery and own source revenue generation. There are, however, legitimate concerns about the ability of the center to respond to macroeconomic needs if too large a share of national resources is guaranteed to LRGs, so that each country must find a workable solution. Generally speaking, however, **central governments must ensure that LRGs receive an adequate and predictable share of nationally raised resources if the SDGs are to be met.**

Different types of transfers are appropriate to pursue different objectives (Table 4). Unconditional grants are preferred for enhancing autonomy and pure redistribution to fiscally weaker local governments, while conditional grants encourage expenditures on priority services. **If designed properly, both types of transfer can encourage local resource mobilization and ensure over time provision of basic minimum services for all citizens in all local government jurisdictions regardless of fiscal capacity.**

Some transfers may also be specifically dedicated to development activities (see below), although it is also essential to provide access to other sources of funding for capital expenditures.

A final core concern with transfers is how they are allocated among LRGs (horizontal balance). The specific allocation **criteria/formula will depend on the goals of the transfer program(s), but an crucial requirement is to distribute funds transparently based on objective criteria** so that they are appropriately targeted and LRGs know why they receive a particular level of transfers.

Equally important, **the transfer system should be designed so that it does not substitute for LRGs' revenue generation activity**--disincentives to collect own-source revenues for operating expenditures or to borrow for financing development expenditures should be avoided in allocating intergovernmental transfers.

Table 4: Basic Types/Objectives of Intergovernmental Transfers

Types of transfers	Revenue Enhancement	Redistribution/Fiscal Equalization	National Priorities
Unconditional	Both types can enhance LRG revenue access but could also create disincentives for good LRG fiscal behavior if not allocated properly	Generally considered best for this purpose, but depends on allocation criteria	Can promote LRG spending but on the priorities that they determine
Conditional		Can be redistributive, but depends on specific purpose/conditions and how funds are allocated	Generally considered best for this purpose, but depends on allocation/monitoring

2.2 Long Term Development Financing

Subnational development finance must be considered in the larger national and international fiscal context. The challenges involved in financing public investments are well known, especially in lower income countries. Public finances, including flows of development assistance, face many constraints and are often subject to considerable volatility. Investment requires long term finance, but short-term financial flows predominate in many cases. The 2008 financial crisis underscored the risks and underlying vulnerabilities in the international financial system, and other shocks--natural disasters, conflicts and disease outbreaks--can dramatically affect public finances and development aid. At the same time, capital is more plentiful and cheaper in the current global environment.

Although there are risks to consider and modalities to work out, there are **great opportunities to use public institutions and resources to leverage private finance for infrastructure investment**, and recent changes in development assistance actors and modalities have also opened the door to creative approaches to development finance, including for LRGs.

LRGs in many low and middle income countries (LICs and MICs) still get much of their funding for long-term development activities from transfers. In advanced industrial economies, LRG access to loans from capital markets has long been an important means to finance infrastructure, a source mostly limited in LICs and MICs to selected larger cities at best. **Even where income levels and fiscal capacity are weak, developing borrowing over time**

can improve the ability of LRGs, particularly in urban areas, to meet growing infrastructure needs.

This often requires **restructuring intergovernmental fiscal frameworks and dedicated efforts to build fiscal responsibility and creditworthiness**.

Development Transfers

Most countries use intergovernmental development transfers to support LRGs key infrastructure, such as schools, health facilities, housing, roads, transportation, etc. Allocation mechanisms for capital transfers vary from ad hoc (often project specific) to formula based. Matching grants (such that a beneficiary LRG must contribute a specific share of the project cost) are not uncommon, but LRG revenues are needed for this to work. Globally LRGs account for nearly two-thirds of public infrastructure investment, about one-third of which is financed with capital grants.[17] **In poorer countries, however, capital grants often play a dominant a role, reinforcing LRG dependence on the center for infrastructure finance. There is much scope to develop alternative sources of LRG long-term finance.** In addition, there must be **better linkages between long- and short-term finance** to avoid the problem of development grants financing infrastructure in the absence of LRG ability and willingness to pay for operation and maintenance.

Borrowing

Municipal credit markets developed gradually and with central support in OECD countries, so such a path must be expected in developing countries. Improving LRG access to loans in developing countries long focused on two main channels: **public or quasi-public municipal development banks/funds (MDBs/MDFs) and commercial loans.** Many countries created an MDB to provide subsidized LRG loans, and there have been some efforts to promote bonds for creditworthy LRGs. MDBs have on balance performed poorly, but often due to weak policies. In some cases they were LRG lending monopolists, and they rarely had enough capacity or incentives to operate effectively. Their close link to central governments and public funding led to politicization of lending decisions (often to non-creditworthy local governments for non-viable projects) and undermined repayment enforcement.

There has been a movement in a growing number of countries to improve LRGs access to development finance **by adopting sound local government borrowing/fiscal responsibility frameworks, pushing revitalized public mechanisms for lending to local governments that operate on more market based principles and opening market borrowing opportunities directly to eligible LRGs**.[18] Leaders on developing fiscal responsibility frameworks have included Argentina, Brazil and South Africa. Several countries, including Columbia and the Czech Republic, have progressively involved the private sector in lending through government initiated mechanisms.

Use of **municipal bonds** has been more limited but some countries have made notable progress, including, for example, Brazil, India, Mexico, the Philippines and South Africa. Even in such cases, however, borrowing tends to be concentrated in larger urban areas. In Brazil, three large municipalities recently accounted for 70 percent of local borrowing.[19] Large municipal corporations have also led local borrowing in India. Loans recently financed nearly a third of total South African municipal capital expenditures, but only 26 of 283 municipalities borrowed recently, and the large metropolitan governments dominated.[20]

In short, **the majority of LRGs in many developing countries are not creditworthy and need help to develop financing strategies and access finance.** A good intergovernmental fiscal system in such circumstances requires **an suitable spectrum of debt finance options, ranging from grants and subsidized (according to clear criteria) loans for poorer LRGs and non-self-financing projects, to various types of loans for more fiscally sound LRGs and self-financing projects**.

The sources and mechanisms of credit for subnational governments vary considerably across countries. Interesting examples include India, Mexico, Philippines and South Africa.

Since the **Ahmedabad Municipal Corporation** first borrowed directly from the capital market in 1998, Indian municipal corporations have raised sizable resources through both taxable and tax-free municipal bonds, with and without state guarantees. State government entities, such as Tamil Nadu Urban Development Fund and Greater Bengaluru Water Supply and Sewerage Project have raised funds through pooled financing that allows municipalities to jointly access capital markets.[21]

[17] See the analysis in Martinez Vazquez and Timofeev (2012).

[18] Some treatment of these matters can be found in Kehew (2005), Platz (2009), Ingram et. al. (2013) and Smoke (2013).

[19] See the discussion in de Mello (2007).

[20] This is detailed in Republic of South Africa (2008).

[21] This is discussed in Government of India (2009).

Mexico has adopted a number of innovative finance mechanisms, including future flow securitization and pooled finance schemes. These are making credit more readily available to a broader range of Mexican municipalities.[22]

In the **Philippines**, much borrowing occurs through mechanisms dedicated to local government finance--the Municipal Development Fund is a public agency (which mixes grant and loan finance) and the Local Government Unit Guarantee Corporation is a private entity promoted by the Development Bank of the Philippines.

South Africa has a number of municipal development finance options, but nearly 70% of local borrowing is through the Development Bank of Southern Africa and Infrastructure Finance Corporation (a private corporation that issues bonds to raise funds for municipal infrastructure lending).[23] Cape Town and Johannesburg have issued municipal bonds, and some other larger municipalities also access private credit mechanisms.

Many of these mechanisms that attract private finance involve creating a separate legal entity structured to meet the requirements of commercial banks and bond investors. The creation of such entities and/or a means of credit support (such as partial guarantees) is often needed for the "typical" LRG in many countries to access finance given their weak fiscal position.

Table 5: Simple Schematic of Local Investment Projects/Finance Mechanisms mix diversity

Type of Investment	LRGs Income Level/Creditworthiness	
	Low	High
Revenue Generating	Mix of Loans (possibly subsidized) & Transfers	Mix of Loans and Bonds
Social Purpose	Transfers Only	Mix of Transfers and Loans (possibly subsidized)

[22] See Giugale, Korobow and Webb (2000), Leigland and Mandri-Perrot (2008) and USAID (2010).
[23] For more details see Republic of South Africa (2008)

If LRGs are relatively strong, developing their direct access to capital markets makes sense if the central government regulates borrowing and enforces budget discipline. In more typical developing countries, where LRGs are fiscally weaker, substantial **use of a separate legal entity** is required.[24] Initial public management or regulation gives the center some control over subnational borrowing, although it must be designed to minimize politicization of lending and repayment. If appropriate, such institutions could increasingly be privatized as LRGs develop creditworthiness, and ultimately they may become obsolete.

At every point in time, LRGs that can tap private finance should do so, and the central government can create an appropriately diverse framework of mixed mechanisms and sources (Table 6). It will often be necessary to develop **other means to facilitate LRG access to credit, such as risk mitigation strategies**. These include comprehensive or partial credit guarantees from the central government or development partners, co-financing initiatives, secondary market support, the use of bond banks and credit pooling, and the use of risk instruments offered by the insurance industry.[25]

Perhaps the key challenge in this process is **how to "graduate" weaker LRGs from grants and subsidized loans to greater use of credit markets.** This requires more coordinated development of grant and loan options.[26] It is critical to ensure that wealthy urban governments do not receive grants for self-financing projects, thereby diverting scarce resources from poorer governments currently unable to borrow.

At the same time, grants and subsidized lending mechanisms must create incentives for weaker LRGs to improve their capacity so that they can begin to borrow, initially through special mechanisms and later on more market-based terms. If, for example, even weak LRGs must borrow for a modest percentage of project finance and they are supported to build the capacity and exercise the fiscal discipline to manage the loan, including raising local revenues for repayment, they can begin a trajectory of building creditworthiness that can progressively improve over time.

[24] One example of a central government support mechanism is the Pooled Finance Development Fund Scheme in India, which provides credit enhancement facilities to subnational governments to enable them to access market loans through a state-level pooled mechanism.
[25] See for example Kehew, et.al. (2005); Petersen (2006); Matsukawa and Habeck (2007), Petersen and Annez (2007).
[26] Grant-loan linkages are discussed and examples presented in Smoke (1999) and Friere and Petersen (2004).

Table 6: Basic Options for Subnational Lending Mechanisms and Sources

	Government Agency	Government Owned Entity	Mixed Public-Private Entity	Private Entity
Mechanisms	Ministry of Finance, Local Government, etc.	Municipal/LG Development Bank, Fund or Utility	Municipal/LG Development Bank or Fund	Commercial Banks, Financial Markets
Sources	CG Budget or External Donors	CG Budget, LG contributions, External Donors	CG Budget, LG Contributions, Private Investors, Depositors, External Finance	Domestic or External Private Finance

Public-Private Partnerships

Public-private partnerships (PPPs) can also support LRGs to secure the expertise and resources they need to help meet their growing development responsibilities.[27] PPPs may--but need not--involve finance generated by a private sector project sponsor. Such an arrangement is at the higher end of the range of possible private sector involvement in PPP (Table 7). Appropriate arrangements depend on specific contexts and projects.

The spectrum of Public-Private Partnerships goes from:

Greater Public Sector Role
From purely public to Operation & Maintenance (OM) to Design-Build-Operate (DBO) to Design-Build-Finance-Operate (DBFO)

Greater Private Sector Role
From Build-Operate Transfer (BOT) to Build-Own Operate (BOO) to pure privatization arrangements.

Although much of the PPP activity for infrastructure development has been through central governments in low and middle-income countries, there have been **growing important advances in subnational PPPs in recent years**, particularly in certain sectors, such as transport, housing and water, Many individual cities have successfully used PPPs, such as Cartagena for water, or Beijing and Rio de Janeiro for public transport systems.

[27] See, for example: Marin (2009), Brinkerhoff and Brinkerhoff (2011), Ingram et. al. (2013), Suzuki, et. al. (2015).

Generally speaking, however, engaging the private sector has been a challenging type of fiscal reform for LRGs in many (particularly but not exclusively low income) countries.

One major concern is that **successful PPPs require a robust legal framework (including strong procurement that may favor certain types of projects and partners) and sufficient LRG capacity to develop and manage them.** The lacks of such conditions and legal impediments have constrained private sector roles in some countries. Developing a PPP framework takes time, requires adoption of responsible LRG fiscal practices (including cost recovery), and often needs national government support.

Despite these challenges, there are opportunities for LRGs to broaden and improve the use of PPPs in service delivery and financing. Some successful subnational government PPPs, such as the Manila Water Company and Sao Paulo's water company, even evolved before the establishment of comprehensive national PPP legislation. Starting points will differ across countries, but most could be able to use PPPs more extensively and productively over time if adequate conditions are reached.

The European Bank for Reconstruction and Development (EBRD) has been a leader in developing PPPs for infrastructure sectors, particularly water and transport, in emerging economies where it operates. The **EBRD approach uses sub-sovereign direct lending with robust funding arrangements and financial and institutional instruments to improve creditworthiness within an off-balance-sheet funding structure**. This approach embeds clear incentives in a two pronged strategy based on a 10-15 year public service contract between an LRG project owner and a service provider and a project or municipal support agreement between the EBRD and the LRG. Together these agreements form a strong foundation for solid performance over a reasonable time frame. Such an approach may well need modifications for use in poorer countries with less capacity than many EBRD clients, but the principles used in the approach can be generally beneficial.

One concern is that PPFs may focus on large-scale projects and the most profitable sectors instead of basic infrastructures and services, especially in disadvantaged LRGs. Yet their broader use **can both reduce demand for funds that could be targeted to needy regions and contribute more generally to strengthening capacities of LRGs**. Over time, this could result in the expansion of sustainable projects and facilitate direct access to funding. Another specific concern with PPPs is **how to frame LRG procurement systems**. LRGs could adopt policies that favor local private sectors (particularly local SMEs) and promote environmental and social goals. For example in South Africa, state procurement has been used to ensure black communities economic advancement, by setting affirmative action requirements that companies bidding for government contracts need to comply with.

In the framework of FfD, some development partners have been supported or proposed the creation of **Project Preparation Facilities (PPFs) to promote investments in infrastructure**.[28]

The **Cities Development Initiative for Asia (CDIA),** a joint initiative of ADB, several European bilaterals and the Shanghai Municipal Government, assists medium-sized cities in the Asia-Pacific region to transform development plans into infrastructure investments with a focus on urban environment, poverty reduction, and climate change mitigation/adaptation. CDIA works with cities to support infrastructure planning, prepare feasibility studies, develop capacities, and connect them to finance. It has involved 55 cities in 14 countries. Project preparation is complete for 58 projects and 26 have been linked to finance, including in Bangladesh, India, Laos and Philippines.

The IFC has also promoted efforts in PPP infrastructure finance, notably with its **Global Infrastructure Project Development Fund**, which seeks to identify bankable infrastructure projects and provides funding for preparing them for implementation. Although the general approach is promising, it focuses on private sector led development projects and is not specifically tied to working with LRGs.

A number of **country-specific PPFs** have also been created. The **Philippines Project Design and Monitoring Facility (PDMF)**, supported by the ADB, Australia and Canada, supports the preparation of infrastructure projects for a nodal PPP Centre attached to the National Economic Development Authority. Other PDFs tailored to the local context have also been created in India, Indonesia and Vietnam. Such initiatives are relatively new but growing rapidly and starting to show impact.

An **Urban Development Fund (UDF)** is a financing vehicle that can bring institutional investors, development finance and the public sector within cities together in a PPP. The UDF would initiate, develop and structure bundled development projects--not transit systems or airports large enough to attract capital individually, but medium-size projects, such as schools, hospitals, energy efficiency systems or biomass plants. The UDP would use planning tools with city-wide engagement, and ownership could be shared by the public and private sectors. Investors attracted by the diversification benefits of an UDP could provide finance, and over time, this vehicle could be rated.

2.3 The Role of International Development Partners

International development partners have played a major role in financing public services in developing countries.[29] There has been some volatility in the overall share of ODA going to support infrastructure (it declined during the privatization focused period that emerged in the 1980s but recovered later), and the sectors being targeted have evolved, but ODA remains very important in some countries. Commitments on delivering ODA remain unfulfilled, including promises made to the LDCs and commitments related to gender equality. DAC countries should respect their commitment to meet 0,7% of their GNI dedicated to ODA with clear and binding timetables and ensure that an increasing share of these funds will reach the poorest countries **(**the Istanbul Program of Action asked that at least 0.15% of GNI through ODA should be concentrated in LDCs**)**.

[28] GIZ (2014), Sachs and Schmidt-Traub (2014), World Economic Forum (2014)

[29] A recent review of the history is provided in Ingram, Liu and Brandt (2013).

Particularly important for this paper, the bulk of ODA resources have been channeled to central governments. Some resources have been routed through the types of municipal development banks outlined above, and other mechanisms noted above (e.g. various types of guarantees for subnational loans) have also been used to get some IFI resources into the hands of LRGs. There are, however, greater **opportunities for development partners to work with LRGs to support their ability to leverage domestic resources to finance infrastructure and local economic development,** some of which were noted above.

An example of an avenue for **IFIs to channel funds to LRGs is the experience of the European Union with EU Structural Funds** (European Regional Development Fund and the European Social Fund) **and the Cohesion Fund**. These funding mechanisms direct resources to local projects in less advantaged areas and require co-financing. Municipalities can raise their co-financing through multiple channels--the capital market, their own contributions or support from regional governments. The European Investment Bank uses this mechanism to support municipal investments through loans/special financial instruments to match EU funds.[30] This approach may be suited for certain areas of MICs like Brazil and India, but it may be less immediately useful in poorer countries. It would also require sufficient capacity and financial safeguards, and should be protected against manipulation for electoral purposes, which has emerged as a concern in the EU[31].

A number of analysts have pointed out the **potentially important role of a strengthened and expanded Multilateral Investment Guarantee Agency (MIGA) in investment risk mitigation under the FfD agenda.** MIGA is the largest political risk insurance provider, but proponents argue that it could serve a larger number of infrastructure projects, including more marginal ones, if certain institutional and procedural reforms were adopted. MIGA's own strategy outlines its ability to support investments at the sub-sovereign level.

Bilateral and multilateral development partners have also played a substantial role more generally in supporting decentralization and LRG reforms in developing countries. Many programs have been set up to enable and help fund the development of intergovernmental structures, local/urban service delivery, local/urban sources of revenue, financial management systems, intergovernmental transfers, public private partnership frameworks, and long-term local/urban finance (through the development of local lending mechanisms and access to financial markets, as discussed above).

Such initiatives, however, have often suffered from problems that have almost surely lessened their effectiveness.[32] First, there has been **a lack of coherence in development partner support for LRGs--separate programs for LRG management, delivery of specific services, particular types of finance mechanisms, etc.** For example, some development partners have supported the decentralization of public services without sufficient support for revenue decentralization. Similarly, some development partners assist with the development of local credit mechanisms without supporting reforms to local revenue and intergovernmental transfer systems needed for local borrowing to succeed.

Second, there has been **fragmentation among and within the same development partners**. For example, there are many documented cases of two different donor agencies independently supporting different mechanisms to promote the same reform or service delivery function. Similarly, there are cases in which one partner was supporting a Ministry of Local Government program to empower LRGs while another concurrently supported a sectoral or public financial management program that unduly constrained local autonomy. More concerted efforts have been made in recent years to identify and correct such glaring donor coordination failures, but much work remains to be done on this front.

More recent developments in both ODA and non-ODA support could have substantial relevance for LRGs:

- First, a number of mainstream development partners are beginning to try to **support LRGs more directly**, for example through city-to-city cooperation and certain innovative finance and capacity development mechanisms, some of which were outlined above in the discussion of LRG borrowing and PPP initiatives.

- Second, **new country actors are emerging** on the development assistance scene--non-DAC actors, such as Brazil, China, India, South Africa and some of the Gulf States, and there may be good opportunities for direct engagement with LRGs.

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[30] European Investment Bank (2014).
[31] Reisen and Garroway(2014)

[32] See, for example, UCLG (2010), Development Partners Working Group on Decentralization and Local Governance (2011), Eaton, Kaiser and Smoke (2011), Smoke and Winters (2011), Kharas and Linn (2013), Dickovick (2014).

- Third, **fairly recently established private actors** (e.g. the Gates and Clinton Foundations) and **special-purpose multi-actor mechanisms** to deal with pressing problems like climate change and global health challenges (e.g. the Global Environmental Facility, the Global Fund to fight AIDS, Tuberculosis and Malaria, the Global Alliance for Vaccines and Immunization) are also very important, and there is much scope for greater and more durable cooperation among such actors and LRGs.

Across all of these traditional development partners and more recent development initiatives and actors, there are many potential ways to make better use of LRGs. Consultations with a range of stakeholders who do not sufficiently interact with each other will be necessary if LRGs are to play more active and productive roles in development

Conclusion

The agenda for enabling LRGs to be stronger players in the FfD agenda is broad and substantial. LRGs in industrialized countries play a greater role in public functions, but also face constraints and need wider and deeper access to finance. In MICs and even LICs, there have been some notable achievements, but the role of LRGs is generally much narrower and access to financial resources is often very constrained.

The policy proposals and recommendations presented above provide an initial agenda for transforming the role of LRGs and strengthening their potential to face the massive infrastructure deficit and global challenges as well as to support more sustainable development in an increasingly urbanized world.

More work is needed to define needed reform efforts in greater detail and to plan a strategy for their effective implementation as part of the larger FfD agenda.

Acronyms

ADB Asian Development Bank
CDIA Cities Development Initiative for Asia
CG Central Government
DAC Development Assistance Committee
European Bank for Reconstruction and Development
European Union
FfD Financing for Development
GDP Gross Domestic Product
GNI Gross National Income
LDC Least Developed Countries
LG Local Governments
LICs Low-Income Countries
LRGs Local and Regional Governments
MDB Multilateral Development Banks
MDF Multilateral Debt Facility
MICs Middle-Income Countries
ODA Official Development Aid
OECD Organisation for Economic Co-operation and Development
PDMF Philippines Project Design and Monitoring Facility
PPF Project Preparation Facility
PPP Public-Private Partnership
SME Small-Medium Enterprises
SN Sub-National
SDGs Sustainable Development Goals
UCLG United Cities and Local Governments
UDF Urban Development Fund
UN United Nations

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