

Founded in May 2004, United Cities and Local Governments (UCLG) is the united voice and world advocate of democratic local self-government. Based in Barcelona, UCLG is the largest local government organization in the world. Accounting for over half the world's population, the cities and association members of UCLG are represented in 136 UN Member States across seven world regions – Africa, Asia-Pacific, Europe, Eurasia, Middle East and West Asia, Latin America and North America. Over 1000 cities are direct members of United Cities and Local Governments, as well as 112 national associations which represent all the cities and local governments in a single country.

For UCLG, the promotion of decentralization as a tool for development is crucial. Local finance is instrumental in any decentralization process and therefore a priority for the world organisation. In 2005, the UCLG Executive Bureau has set up the **Committee on Local Finance and Development**, operational since 2006 with the support of Cities Alliance. The Committee is made up of more than 40 leading mayors and representatives of local government associations and delegated responsibility for drafting the UCLG Policy Paper on Local Finance. The Policy Paper sets out to give voice to a local government vision on financing with particular emphasis on how the relationships between local governments, multilateral organisations and national governments would ultimately shape such a process.

The Policy Paper is an executive summary of the principle findings and recommendations from a broader technical paper, the UCLG Support Paper on Local Finance. This work, in addition to the overall activity of the Committee has four key objectives: promoting financial autonomy of local governments; broadening access to finance for local public infrastructure; sharing experiences; advising UCLG members on matters related to municipal finance and resource mobilization.

UCLG POLICY PAPER ON LOCAL FINANCE

UCLG POLICY PAPER ON LOCAL FINANCE

Including the UCLG Support Paper



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Cities Without Slums



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UCLG POLICY PAPER ON LOCAL FINANCE

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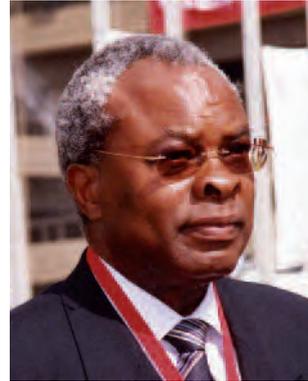


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FOREWORD



Dear Colleagues and Friends,

It is my great pleasure, as chair of the UCLG Committee on Local Finance and Development and Mayor of Maputo, to present you with the UCLG Policy Paper on Local Finance and its Support Paper.

The Paper is the result of a joint effort initiated in 2005 through the establishment of the Committee with the support of Cities Alliance and adopted at the 2007 United Cities and Local Governments World Congress in Jeju, Korea. The Policy Paper seeks to give voice to a local government vision on financing and stems from a shared understanding of the challenges we face.

If no radical change occurs in the coming years, current underinvestment in urban infrastructure will lead to dramatic social and environmental upheavals for what is rapidly becoming an increasingly urbanised global population. Investment in urban infrastructure for the future is about having a vision: "no longer can local governments and stakeholders afford to wait until a major crisis forces a massive uptake in local public infrastructure. Similar crises are sadly well underway in many countries – meeting the challenges they are certain to pose in the coming years means investing in the future now".

Today, local governments are faced with the challenge of urbanization yet so often are lacking the financial means to meet that challenge. If we want to tackle urbanisation, the local government financial system as a whole must be rethought, reshaped, redone.

The Policy Paper contains 25 concrete recommendations for increasing local government access to infrastructure financing, particularly in developing country cities where infra-

structure planning and construction have not kept pace with rapid urbanisation.

The recommendations call on local governments, central governments, donors, and international financial bodies to address urban expansion and the accompanying infrastructure requirements by redirecting development aid, and establishing national strategies to boost local public investment.

At the global level, UCLG advocates that at least 20 percent of development aid and debt relief be allocated directly to local governments to enable them to address poverty reduction through public infrastructure provision.

At the country level, UCLG proposes boosting local public investment through several courses of action: increased local government autonomy, fiscal decentralisation, regular financial transfers from central to local governments, revenue generation at the local level, and improving the ability of local governments to borrow.

In order to meet the challenges set out in the paper, we hope to count on your support and participation in the task force that will take on the much needed bold reforms.

I look forward to working with you soon.

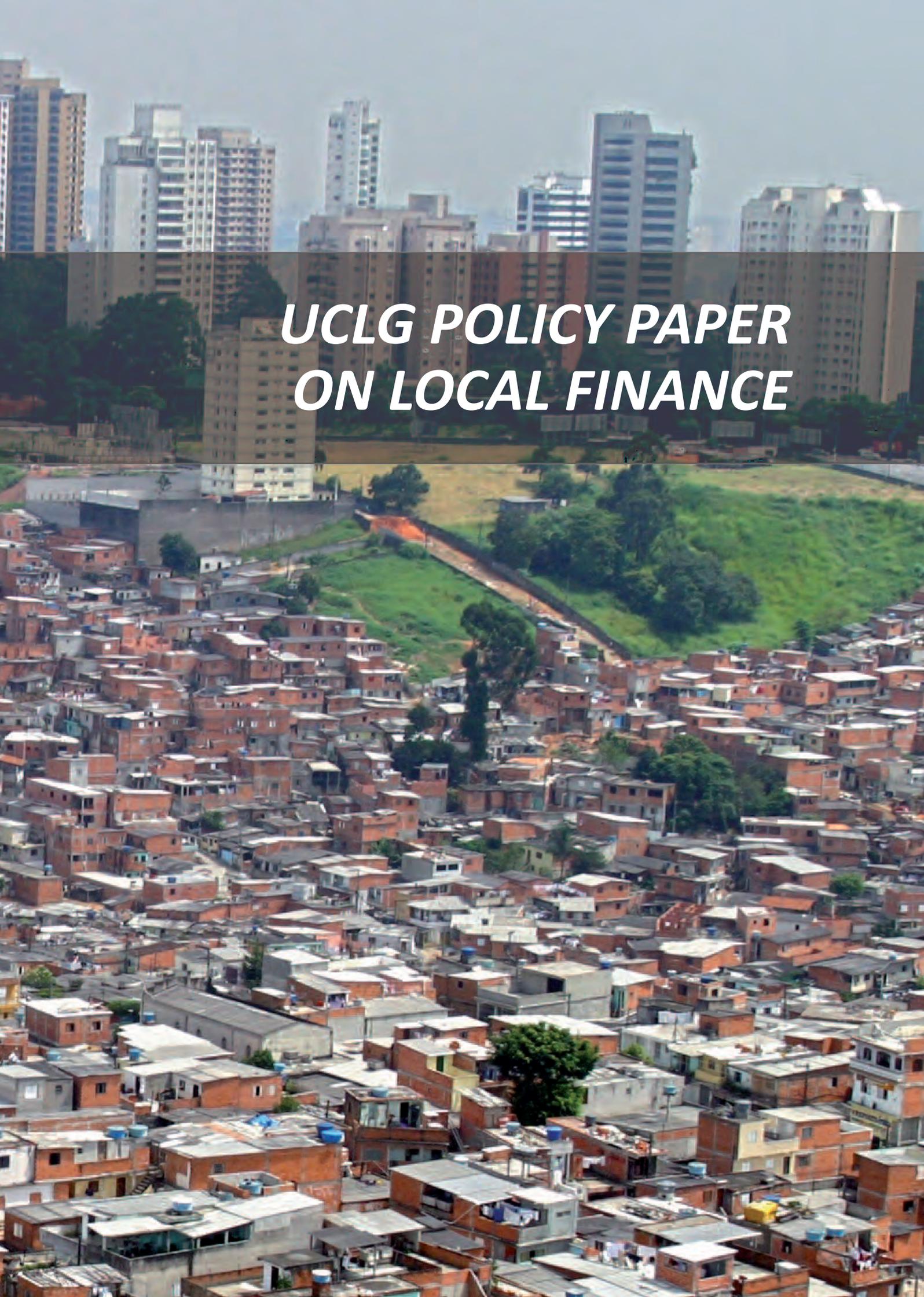
Sincerely,

Eneas Comiche
Mayor of Maputo
Chair of the UCLG Committee on
Local Finance and Development



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***UCLG POLICY PAPER
ON LOCAL FINANCE***

SETTING THE BACKGROUND: CURRENT TRENDS AND REALITIES FACING LOCAL GOVERNMENTS

The world is witnessing unprecedented urban explosion. The urban population has more than quadrupled since 1950 amounting to 3.2 billion in 2005 and should reach 5 billion people in 2030 (about 60% of the World population). According to the UN, 95% of urban growth over the next 20 years will occur in Asia, Africa and to a lesser extent in South America (where the demographic urban transition has already taken place) and especially in small and medium size local governments.

Fast growing urbanization is giving rise to a major and pressing need for future infrastructure projects that are expected to cost some USD 200 billion per year over the next 25 years¹. However, these infrastructure needs are currently being unmet. Failure to invest in infrastructure has already impacted severely upon the daily lives of millions of citizens in developing countries. If nothing is done, one human being in five will be living in a slum by 2020, especially in Africa and Asia. No longer can local governments and stakeholders afford to wait until a major crisis forces a massive uptake in local public infrastructure. Similar crises are sadly well underway in many countries – meeting the challenges they are certain to pose in the coming years means investing in the future now.

Paradoxically, the current underinvestment in urban infrastructure coexists with a significant amount of liquidities at the international level, as well as relatively high cash and national savings, which tend to be invested abroad, especially in developing countries.

Within this context, what are the usual solutions put forward by the international community to face these inevitable crises and invest rapidly and massively in urban infrastructure?

Development banks finance few urban infrastructure projects², and only exceptionally do they lend to local governments. Numerous international institutions tend to privilege Public Private Partnerships (PPP), despite the fact that they are marginally focusing on urban infrastructure³. The more than seventy Municipal Development Funds that were set up in the South with development banks support, to finance local infrastructure are now experiencing several difficulties, aggravated by the lack of a global strategy for small and medium sized local governments. Local public borrowing is another macroeconomic solution promoted by the international community – though currently accessed only by local governments of the wealthy countries⁴. In many devel-

1. *The World Bank has estimated that investment needs in public infrastructure in developing countries will amount to USD 600 billion per year over the next 25 five years. The UCLG Committee has estimated that one third of this amount, i.e. 0.4% of the World GDP, would need to be channelled to urban infrastructure.*
2. *Within the World Bank Group, only 8% of the total amount of loans (worth USD 22.3 bn in 2005) was assigned to urban infrastructure and development (USD 1.9 bn).*
3. *According to a World Bank study, over the 1984 2003 period, PPP focusing on urban infrastructure came to only to USD 60 bn (i.e. 10% of the total of investments realized through PPP over this period) in just a handful of countries of South America and East Asia.*
4. *AFD research has shown that local public borrowing is about USD 12 bn per year in mainly 17 countries (which include the G7 countries).*

oping countries, longer transition periods would be required to enable financial markets and credit market to develop and provide loans to local authorities. Moreover, IMF-induced structural adjustment programmes have generally had a negative impact on public investment, at both national and local level, and thus on the development of these markets.

Development agencies and donors have adopted new urban strategies, yet the outcomes are not yet proportionate to the challenges. Most donor-driven development programmes are focused on funding small scale infrastructure projects for local communities, however often outside local governments' operational frameworks and planning. Land and asset management is also often presented as a way to finance local public infrastructure, but it requires several preconditions and tools (like a cadastre) that are precisely lacking in developing countries. The fact that it still remains impossible to assess the portion of the USD 100 bn spent annually on official development aid that goes to local governments and local infrastructure, is quite telling in itself.

With regard to the challenges of urban explosion, other options for more fundamental change must be explored and developed. These changes should take local governments more fully into account.

Historically, in developed countries, public sector has played an important role in fostering urban development and in particular in mobilising finance for local public infrastructure. When vested with sufficient funding, local governments have been successful in investing in urban infrastructure for the future. Positive examples of which can also be found in developing countries. Local governments are well positioned to manage investment at the local level primarily because they understand their citizens' demands and priorities and are accountable to them. This process not only benefits the citizens themselves but at the

same time produces positive national growth outcomes.

However, to enable local governments to take on this investment role, various courses of actions should be taken on both the demand and supply side of financing. In of themselves these reforms would undoubtedly produce positive outcomes at all level of government.

On the demand side:

If we want to meet head on the challenge of growing global urbanization, the local government financial system as a whole must be reshaped, rethought, redone, as well as local government capacity building mechanisms. To boost local infrastructure, financial autonomy must be increased, firstly by giving local governments responsive resources of their own and secondly by ensuring that transfers from central government are regular, predictable and transparent, a prerequisite for investment budget planning. Vested with adequate financial means and supported by their partners, local governments will be able to raise their operational and human capacities to implement and follow up investment projects. In return, they would commit to high standards of transparency and accountability.

On the supply side:

Significant efforts are needed to provide local governments with effective access to finance, credits and loans, to realize the needed local public infrastructure. Given that private markets and banks are not serving local governments, (mainly for structural reasons), public intervention is often needed to promote local public infrastructure long-term financing, whether through the funding of financial institutions and the development of specific legislation. In particular, the procedures of finance

bodies that specialize in lending to local governments (the so called Municipal Development Funds) need to be reviewed to allow small and medium-sized authorities greater access to long-term borrowing in

their local currency and at affordable rates of interest. Innovative mechanisms, aimed at freeing up available local savings and cash assets for local infrastructure, should be envisaged and implemented.

MEETING THE URBAN CHALLENGE: 25 RECOMMENDATIONS FOR ENABLING EFFECTIVE LOCAL GOVERNMENT ACCESS TO LOCAL INFRASTRUCTURE FINANCING

The UCLG Committee on Local Finance and Development has elaborated twenty-five recommendations. The first two global recommendations aim at the swift provision of additional financial means to Southern local governments to invest in infrastructure (A). The other twenty-three recommendations should be interpreted and prioritized on a country to country basis, and embrace both demand and supply side of financing (B).

A. Redirect Development Aid to the Sphere of Government Closest to the Citizens to Tackle Urban Explosion:

1. Channel 20% of development aid to the sphere of government closest to the citizens.

UCLG proposes that at least 20% of public development aid (about USD 20 bn) be allocated directly to local governments or through decentralised co-operation.

2. Ensure that local governments benefit from the revenue made available as a result of debt relief under the HIPC and MDRI in the respective 29 countries.

Donors and multilateral financial institutions are called to ensure that local governments benefit from the revenue made available as a result of debt relief under the HIPC (Heavily Indebted Poor Countries Initiative) and MDRI (Multilateral Debt Relief Initiative) initiatives.

UCLG proposes a target of 20%, meaning that at least 20% of these financial resources (amounting to an estimated total of USD 153 M in 2006) should go to the budgets of the local governments in the respective 29 countries enabling them to address poverty reduction through local development public infrastructure.

B. Establish National Strategies to Boost Local Public Investments:

1— Measures to be taken on the Demand Side of Financing (local government capacity to raise finance):

- 1.1. Enhance local governments' financial autonomy by ensuring them with adequate funding.

Central governments are called to:



3. Ensure that local governments are vested with sufficient funding for implementing the functions that have been delegated to them. This implies putting an end to the practice of unfunded mandates.
4. Guarantee regular and predictable financial transfers to local governments and put responsive fiscal instruments in place.
5. Adapt fiscal tools to the new economic realities, such as the knowledge-based economy and globalization. This would enable central and local governments to review the sharing of public revenues in a positive context.

Local governments should commit to:

6. Improve the collection of local taxes and fees, when applicable.
7. Strengthen the advocacy role of local government associations and support their training capacities in the area of local finance.

Donors, Multilateral and Bilateral financial institutions are called on to:

8. Support local governments and their partners in developing enhanced fiscal decentralization frameworks.

1.2. Link financial autonomy and accountability.

Central governments are called to:

9. Allow the generation of significant local government own revenues.
10. Support the capacity development of local governments.

Local governments should commit to:

11. High standards of efficient manage-

ment and transparency, in return to the additional financial means provided.

12. Develop their capacities and pro-actively participate in peer to peer practices.
13. Promoting citizen participation.

2— Measures to be taken on the Supply Side (credit and grants made available to local governments):

- 2.1. Reform credit mechanisms and financial tools to enhance local governments' access to borrowing.

Central governments are called on to:

14. Allow local government's effective access to borrowing by building a conducive environment for financing local infrastructure.
15. Reform Municipal Development Funds, in particular through the evaluation of finance provided to small and medium local governments and involving local governments in their management board.

Local governments should commit to:

16. Be proactive in proposing new policies and promoting innovative mechanisms (e.g. the Bank of Cities project).

Multilateral financial institutions and donors should:

17. Establish a coherent global strategy to meet the investment needs of small and medium-sized authorities. This will necessarily require a revision of their existing commitments.
18. Increase the volume of loans directly channelled to local governments, with or without sovereign guarantee.

19. Improve the quality of the loans provided by: extending the period of loans; reducing the interest rates offered through grant blending; and lending in national currency.

2.2. Strengthen together aid effectiveness, transparency and ownership.

Financial institutions and donors are called on to:

20. Improve efficiency and transparency of development programmes, consistent with the Declaration of Paris on Aid Effectiveness, and systematically include local governments in the design and implementation of aid instruments.

21. Contribute to improved cooperation between UN agencies, in line with the recommendations of the UN reform panel, mandated by Kofi Annan on the UN reform⁵.

3— Complementary and alternative proposals to boost local public infrastructure financing:

Central and local governments are called to reform national and local public enterprises providing basic services at the local level:

22. Review pricing policies to cover operational costs and set up perequation systems to facilitate access to basic services for the urban poor.

23. Improve the articulation between development plans of these utilities and local government ones.

Local governments and their partners are called to improve linking urban and financial planning:

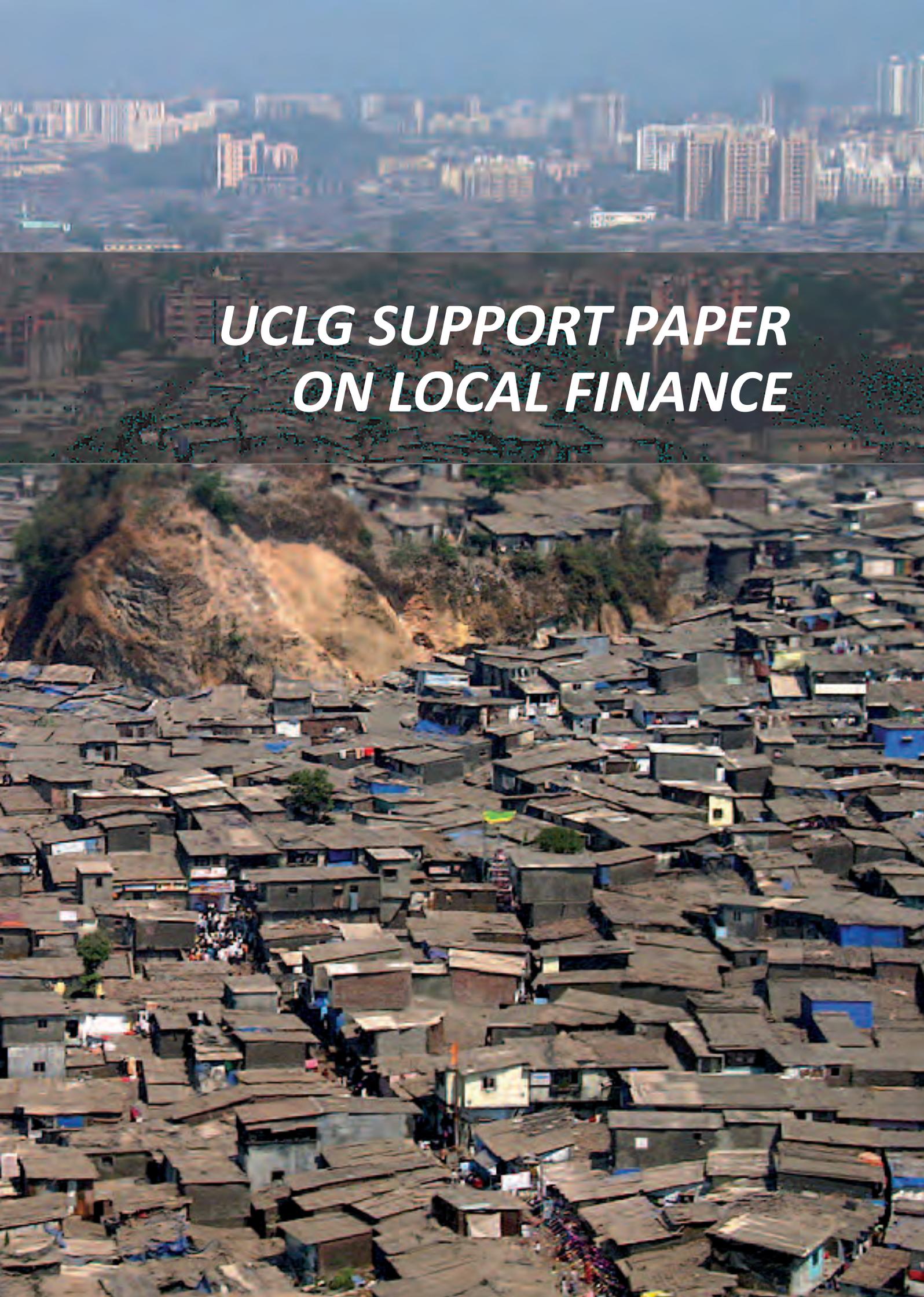
24. Elaborate realistic multi-annual investment plans with funding sources identified in relation to the master plan.

25. Review fiscal tools to discourage urban sprawl and promote compact urban development.

5. According to the report issued by the panel, between 2004-2005 UN agencies supervised programmes worth more than USD 45 bn (about € 40 bn). Implementation was mostly fragmented way, with sometimes more than 20 agencies managing less than one million dollars each within a single country programme.



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An aerial photograph showing a stark contrast between urban development. The foreground is dominated by a dense, sprawling informal settlement with numerous small, closely packed buildings, many with flat roofs. The background features a modern city skyline with several tall, multi-story apartment buildings under a clear blue sky. The text 'UCLG SUPPORT PAPER ON LOCAL FINANCE' is overlaid in white, bold, italicized font across the middle of the image.

***UCLG SUPPORT PAPER
ON LOCAL FINANCE***

EXECUTIVE SUMMARY

SETTING THE BACKGROUND: CURRENT TRENDS AND REALITIES FACING LOCAL GOVERNMENTS

Local Governments are Facing the Urban Challenge but often Lack the Financial Means to Tackle it:

- Urbanisation is giving rise to major and pressing needs for infrastructure that are going unmet at the moment, estimated to be around USD 200 billion a year for the next 25 years. Consequences of this lack of investments are already witnessed especially in Southern local governments.
- As implemented, the various forms of local finance available today are only partially able to meet these financing needs. They consist of local taxes and intergovernmental transfers, public-private partnerships, national and local publicly-owned companies responsible for developing and running public services, the management of municipal assets and urban land, public development aid and action led by development banks, and last but not least linking domestic capital to local public investment.
- As shown on numerous occasions both past and present, the financial autonomy of local governments allows them to borrow and to finance required local infrastructure. When vested with sufficient financing, local Governments are the best placed to manage investment at the local level as they are in touch with their citizens and know their priorities. This is not only beneficial to their citizens but also to national growth. Financial autonomy, a precondition of investment, must be increased, firstly by giving local governments responsive resources of their own, and secondly by ensuring that transfers from central government are regular, predictable and transparent, a prerequisite for investment budget planning.
- Allowing local governments to borrow funds also calls for reforms to be made in the financial sector so that the available local saving and cash assets, which tend to be placed abroad, can be used to finance local infrastructure. Local governments emphasise the many difficulties that small and medium-sized authorities face in accessing credit (offered interest rates that are too high, the lack of partners over the duration, negotiations regarding loans that sometimes last longer than the local representative's term in office) and the severe negative impact of the irregularity of transfers from central governments. In particular, the action of financial bodies that specialise in lending to local governments (so called municipal development funds) needs to be reviewed to allow small and medium-sized authorities greater access to long-term borrowing in their local currency and at affordable rates of interest.

In order to reach the urban infrastructure investment required, it seems relevant to the local governments to set measurable targets in the recommendations that were elaborated through a large consultation with local governments, regarding on one hand the demand side of financing (local governments capacity to raise finance) and on the other hand the supply side of financing (reform the financial sector, lending tools, grants and development programmes towards local governments).

MEETING THE URBAN CHALLENGE: RECOMMENDATIONS FOR LOCAL GOVERNMENTS EFFECTIVE ACCESS TO LOCAL INFRASTRUCTURE FINANCING

If no radical change occurs in the coming years, the current underinvestment in urban infrastructure will bear dramatic social and environmental consequences within a context of an increasingly urban population.

To broaden this access, several actions must be taken on both demand and supply side of financing. The recommendations set below are displayed in the UCLG Policy Paper.

They should be interpreted and prioritized for each country, in a commonly elaborated national strategy that would also include a strategic implementation process suggesting in particular a sustainable funding mechanism for its achievement. The possibility of reaching national agreements between partners (central government, local governments, lenders and donors) would improve the implementation of these recommendations at the national level.

To tackle urbanization, four basic steps are recommended: enhance local governments' financial autonomy, link financial autonomy and accountability, reform credit mechanisms and financial tools and re-direct development aid to the local governments.

- Central governments are called to:
 - Ensure that local governments are vested with sufficient funding for implementing the functions that have been delegated to them (Stop the practice of unfunded mandates).
 - Guarantee regular and predictable financial transfers to local governments
- Donors are called to:
 - Adapt fiscal tools to new realities, such as knowledge-based economy and globalization.
 - Allow local government's effective access to borrowing by building an environment conducive to financing for local infrastructure from domestic savings and available liquidities, and in particular by reforming municipal development funds.
- Multilateral financial institutions should:
 - Ensure that local governments benefit significantly from public development aid. UCLG would propose that at least 20% of public development aid (about USD 20 bn) are allocated to local governments and through decentralised co-operation.
 - Systematically include local governments in the design and implementation of aid instruments intended for local government and decentralization.
- Multilateral financial institutions should:
 - Ensure that local governments benefit from the revenue made available as a result of debt relief under the HIPC (Heavily Indebted Poor Countries Initiative) and MDRI (Multilateral Debt Relief Initiative). UCLG would propose a target of 20%, meaning that at least 20% of these moneys (amounting to an estimated total of 153 M USD in 2006) go to the budgets of the local governments in the 29 countries concerned.
 - Devise a coherent global strategy to
- and put responsive fiscal instruments in place.
 - Adapt fiscal tools to new realities, such as knowledge-based economy and globalization.
 - Allow local government's effective access to borrowing by building an environment conducive to financing for local infrastructure from domestic savings and available liquidities, and in particular by reforming municipal development funds.

meet the investment needs of small and medium-sized authorities.

- Present mechanisms for extending the period of loans and for reducing the interest rates offered to local governments.
- Systematically include local governments in the design and implementation of aid instruments intended for local governments.
- Local governments should commit to:
 - Improve the collection of local taxes and fees, when applicable.
 - Commit to high standards of efficient management and transparency, as well as promoting citizen participation.
 - Develop their capacities and get involved in peer-to-peer practices.
 - Strengthen the advocacy role of local government associations and support their training capacities in the area of local finance.
 - Be proactive in proposing new policies and promote innovative mechanisms such as the “Bank of Cities”.

Complementary and alternative proposals to boost local public infrastructure financing have been made:

- Reform national and local public enterprises providing basic services at the local level. Central and local governments are called to:
 - Review pricing policies to cover operational costs and channel subsidies towards the urban poor.
 - Improve mutual information and coordination with local governments planning to enhance infrastructure coverage and funding.
- Linking urban and financial planning. Local governments and their partners are called to:
 - Elaborate realistic multi-annual investment plans with funding sources identified in relation to the master plan.
 - Review fiscal tools to discourage urban sprawl and promote compact urban development.

BACKGROUND

THREE LONG-TERM TRENDS AFFECTING OUR WORLD

Local governments are deeply affected by three long-term trends that have changed and are still changing our world:

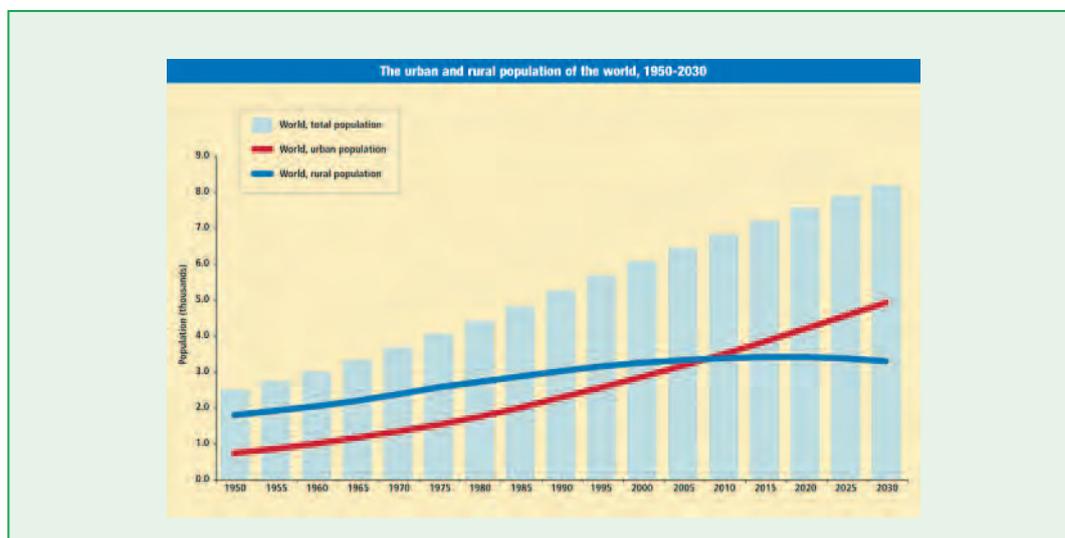
- 1 Urbanization and Development
- 2 Decentralization
- 3 Globalization

1. Urbanization and Development

In 2007, for the first time in history, the majority of the world's population is living in cities. This urbanization has been durable, rapid and accelerating if we consider that the global proportion of urban population was only 3% in 1800, 13% in 1900 (220 million urban dwellers) and

30% in 1950 (732 million). The urban population has more than quadrupled since 1950 to amount to 3.2 billion in 2005. According to UN projections, about 5 billion people are expected to be urban dwellers in 2030 (60% of the population).

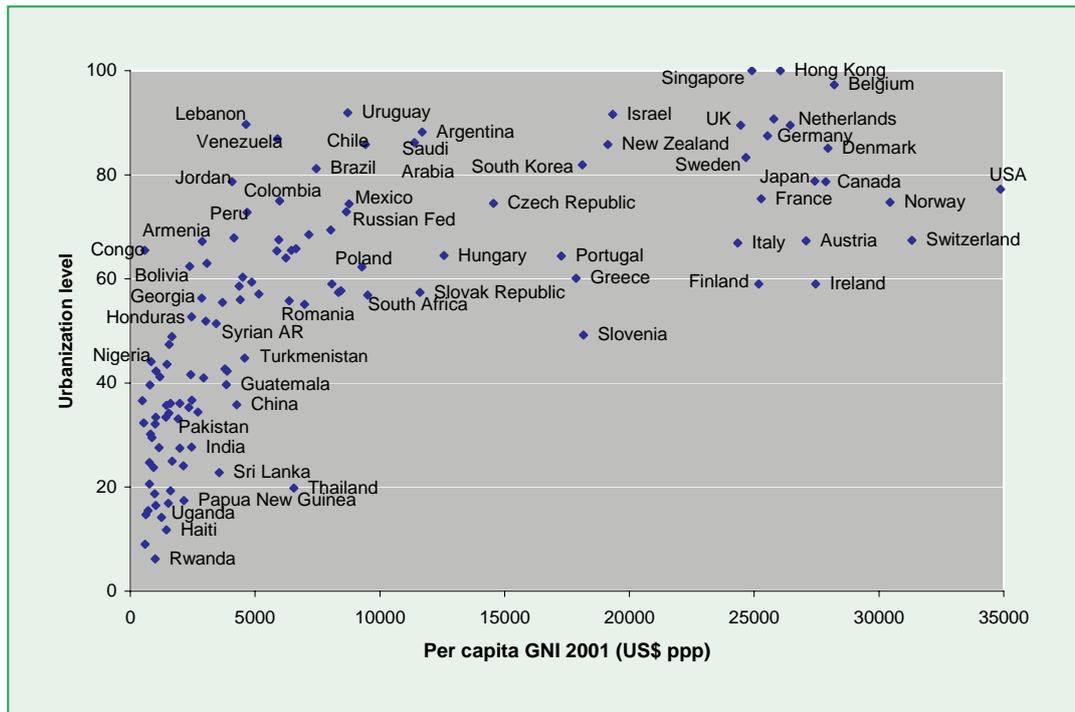
This swift urbanization characterizes and generates major social changes as cities offer economic opportunities and social advancement prospects but also deeply modify demographic behavior. Rapid urbanization brings challenges of huge proportions (especially in terms of environmental sustainability and social cohesion) as well as opportunities (economic growth and poverty reduction, improved urban planning). As portrayed in the following graph, there is a positive correlation between the level of urbanization and income per capita: the more



Graph 1
Urban and rural population of the world, 1950-2030.

Source: World Urbanization Prospects : The 2005 Revision, UN.

Graph 2
The Association between Nations' Level of Urbanization and their Average per Capita Income, 2000/2001.



Source: The Ten and Half Myths That May Distort the Urban Policies of Governments and International Agencies, David Satterthwaite.

urbanized a nation, the stronger its economy. Cities are definitively the growth engine of nations.

Finally, this urbanization trend gives room for the demands of local people to take charge of their own business and the call for local powers and local authorities.

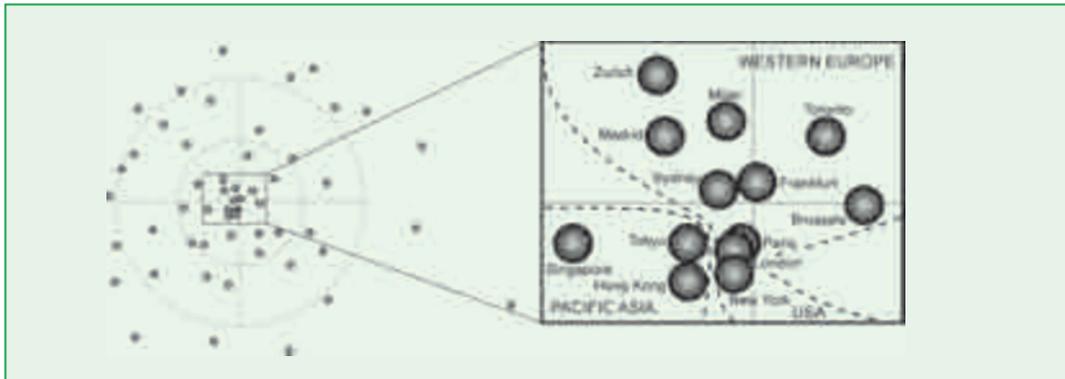
2. Decentralization

As a matter of fact, decentralization is a worldwide process, developing in all regions at the same time. The increase of local elections and mayors elected as well as new functions vested at the local level are the most visible signals of this political and administrative decentralization over the world. The First World Decentralization Report (GOLD) provides extensive information on this global movement.

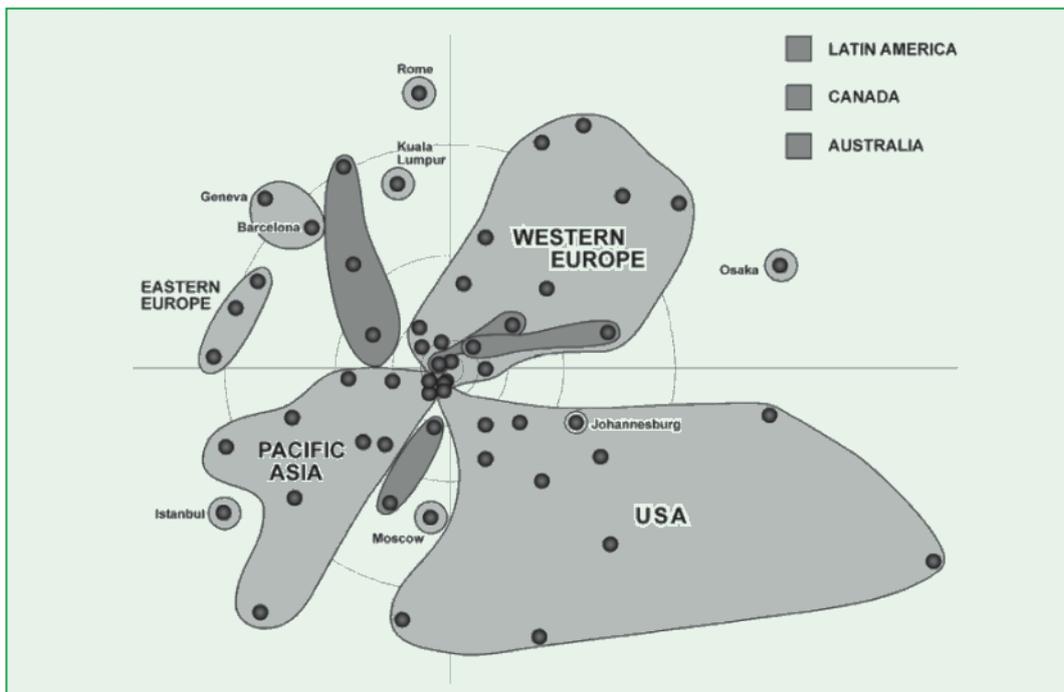
3. Globalization

Globalization, stated as an increasing glob-

al connectivity, integration and interdependence in the economic, social, technological, cultural, political, and ecological spheres, has a massive direct and indirect impact on local governments. While transnational processes are leading to the erosion of the efficacy of the state boundaries, globalization tends to reassess the positioning of cities, as main stakeholders and actors of a global network society, where interconnectivity and information flows predominate. To perceive what is globalization about, and try to shape the new flows and networks in motion, some authors have developed a new mapping of the world, as a complement to the traditional world map of countries. Based on the analysis of service connections between cities, and on the location strategies of leading corporate service firms, this new mapping of the world shows a centric structure with the major world cities at the core (Graph 3). Three majors regions appear, grouping centre to their periphery, irrespective of national boundaries (Graph 4).



Graph 3
Cities at the Centre of Global Service Space.



Graph 4
Regional Tendencies in Global Service Space.

Source: A New Mapping of the World for the New Millennium. P.J. Taylor, M. Hoyler, D.R.F. Walker and M.J. Szegner, Globalization and World Cities Study Group and Network.

Globalization is heavily impacting on local governance in many different ways. An enhanced competition amongst cities for attracting foreign direct investments, which requires high level urban infrastructure, can be witnessed. Cities compete for world events (Olympic games for instance) and world branding (Dubai is for instance launching several mega projects such as the two tallest towers). Local economic development and city wealth appear to be even more connected to revenues realized outside the local territory.

This is not without consequences on local finance. Local taxation is increasingly questioned; because of fiscal dumping, fiscal evasion and obsolescence, as aging local and national taxes are not related to the new sources of wealth that develop with the knowledge economy. Moreover, globalization generates swift changes in the wealth of nations, which impacts national public finance and national investment capacities – and therefore local finance and local public investment. For instance, while historically developing economies were re-



lying solely on capital investment from developed economies, these countries have been experiencing since 2000 rising surpluses, enabling them to use these revenues to boost their economies and invest. This is an opportunity for local governments in these countries for financing their needs.

Urbanization, decentralization and globalization are deeply changing the world. These trends are positioning local governments as a key actor and factor of the urban change, as well as making local governance much more complex.

To be able not only to follow but to plan and accompany these trends, local governments must be appropriately equipped, in terms of policy making and implementation capacities, which require adequate resources. Do local governments have the financial means to tackle the most burning issues ahead? To what extent do local finance frameworks adapt to these long term trends?

The aim of this support paper is to focus on the challenges that local governments are facing and to explore the reform in local finance that will support them.

**THE CONTEXT:
THE URBAN INFRASTRUCTURE
CHALLENGE**

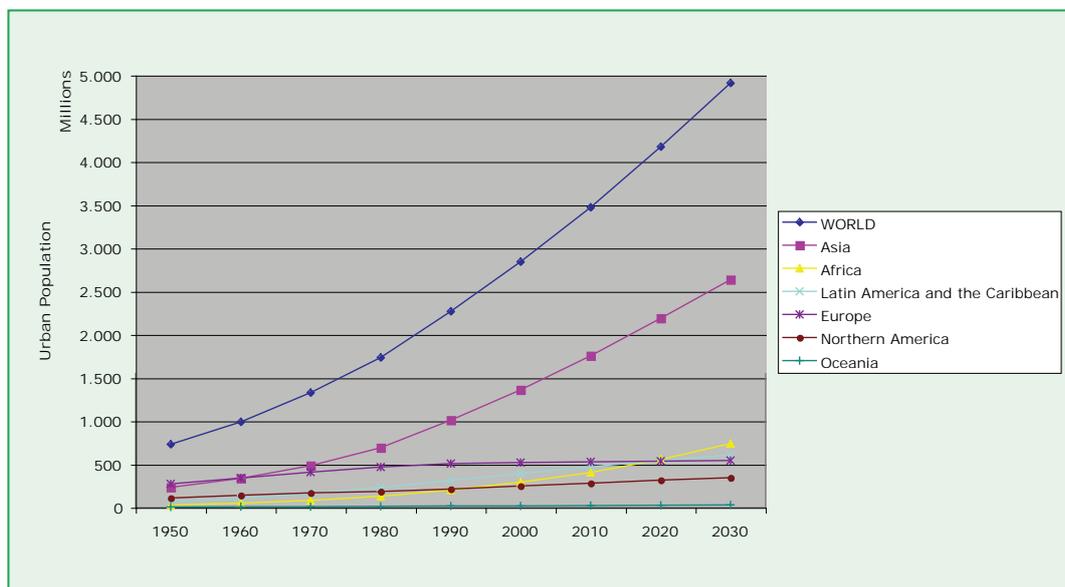
1. A RAPID URBAN POPULATION GROWTH AND URBAN GROWTH PATTERN WHICH REQUIRES MASSIVE INVESTMENT IN LOCAL PUBLIC INFRASTRUCTURE

- A swift urban population growth

A rapid urban population growth is witnessed in Asia (+4.29% per year from 1950 until 2005) and is expected in Africa, especially in small and medium size cities. According to the UN report "State of the World's Cities 2006/2007", 95% of urban growth over the next 20 years will occur in Asia, Africa and to a lesser extent in South America, where demographic urban transi-

tion has already taken place (76% of the population is already urban).

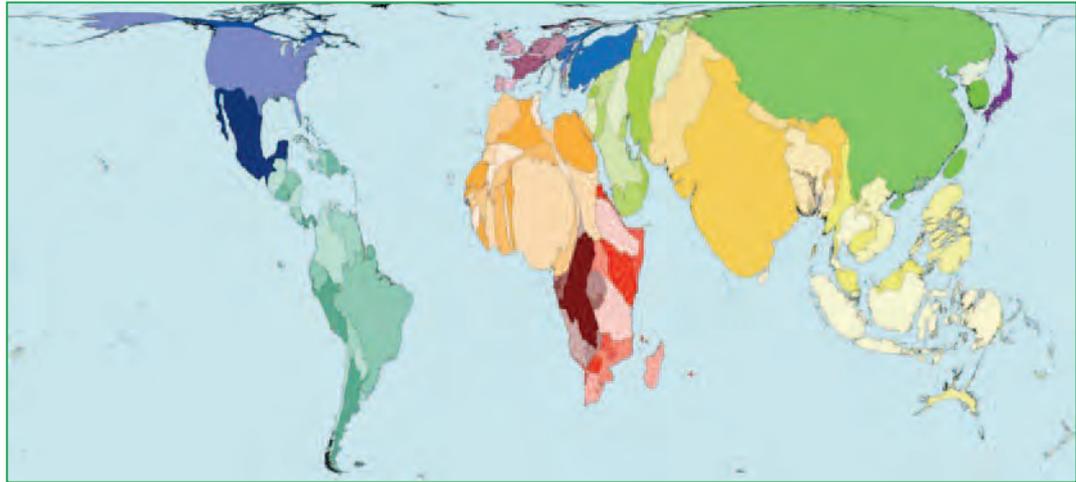
The future growth of world urbanization is estimated at 1.78% per year over the next 25 years. In the two least urbanized regions of the World, Africa and Asia (where respectively 38% and 40% of the population is today urban), this rate is expected to be correspondingly 3% and 2.12% per annum.



Graph 5
Urban Population
by Region, 1950-
2030.

Source: UN Department of Economics and Social Affairs/ Population Division. World Urbanization Prospects: The 2005 Revision.

Graph 6
Expected Urban
Growth between
2002-2015.



Note: Territory size shows the proportion of all extra people that will start living in urban areas between 2002 and 2015, in each territory.

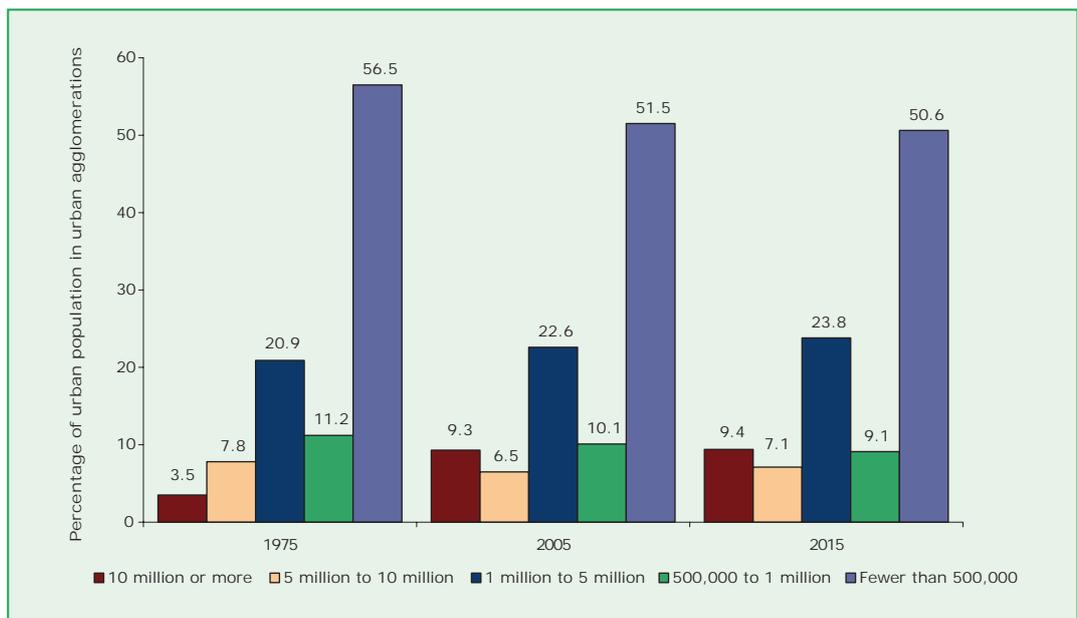
Source: World Mapper; City Growth.

- Small and Medium Cities at the Forefront

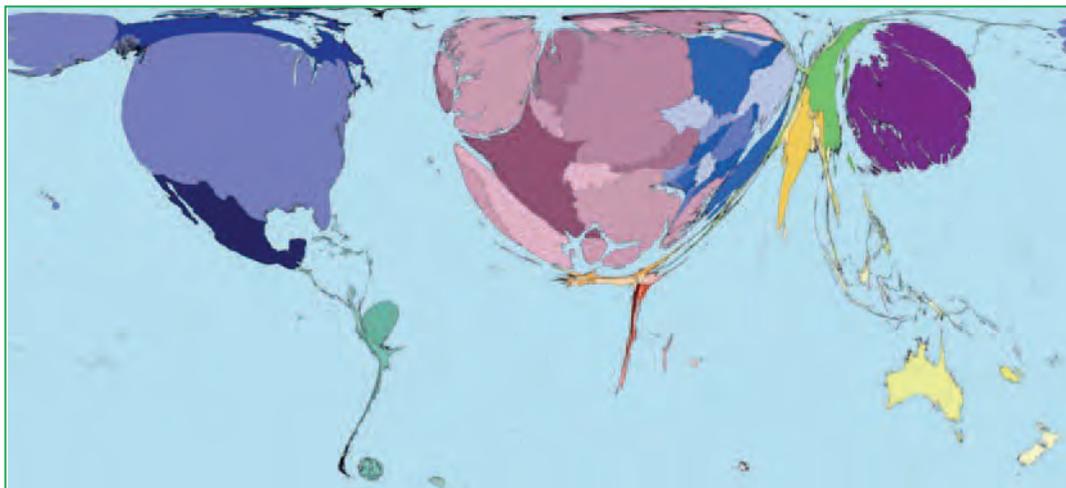
The majority of the urban population is living in small and medium cities and this should remain globally unchanged, given that the expected urbanization growth will occur essentially in small and medium size cities (below 500.000 inhabitants). Megalopolises (over 10 million inhabitants) are

not expected to grow bigger, while urban areas from 1 to 5 million should marginally increase their share of urban population. Therefore, the massive investment in local public infrastructure required to tackle this urban challenge and service this rising population will need to be directed where it is the most needed, essentially to small and medium municipalities.

Graph 7
Percentage of Ur-
ban Population
Residing in Urban
Agglomeration by
Size of Urban
Settlement,
1975, 2005 and
2015.



Source: UN Department of Economics and Social Affairs/ Population Division. World Urbanization Prospects: The 2005 Revision.



Graph 8
The infrastructure divide: Proportion of People Accessing Connected Toilets to Public Sewerage Systems.

Note: Territory size shows the proportion of all people that have their toilets connected to public sewerage systems (and thus waste water treatment) that live there.

Source: World Mapper; Sewerage Sanitation.

- Investments in Urban Infrastructure do not Match Urban Expansion

The level of infrastructure investment does not yet match the needs of the population, especially in Africa, Latin America and Asia, leading to the so called infrastructure gaps or backlogs. The consequences of insufficient investment in urban infrastructure are already witnessed in cities.

In many countries, due to the lack of core urban infrastructure and urban planning, slum growth is tackled with difficulty and it is sometimes even higher than urban growth. The provision of basic urban services appears also insufficient in many regions.

The difficult question remains to assess the level of funding that would be necessary to provide this required public urban infrastructure. Given the lack of data, only estimations can be made.

One starting point is to use the World Bank analysis of investment needs in public infrastructure in developing countries, amounting to USD 600 billion per

year over the next 25 five years. This assessment is based on a macro-economic statement according to which Middle income countries should spend up to 5.5% of their GDP (about USD 460 bn) in maintenance and development of infrastructure, and Low Income countries up to 7% of GDP (which amounts to USD 1.100 bn) to keep up with their growth. However, these figures include all public infrastructures, whether national (energy, communications and information technology, transport; water and sanitation, etc.) or urban (local roads, local water supply, and sanitation, waste disposals, schools, street lightning...).

REGION	Lacking Water	Lacking Sanitation
Africa	100-150 M 35%-50%	150-180 M 50%-60%
Asia	500-700 M 35%-50%	600-800M 45%-60%
Latin America and the	80-120 M 20%-30%	100-150M 25%-40%

Table 1
Number (Million) and Share of Urban Dwellers Lacking Adequate Provision of Water and Sanitation, by Region, 2000.

Source: 2007 State of the World, p. 27, The World Watch Institute.

If we try to focus strictly on urban infrastructure, the total cost of meeting only target 11 of the Millennium Development Goals, (slum upgrading for 100 million existing slum dwellers, new sites construction for 700 million potential future slum dwellers) would be about USD 1.300 bn, i.e around USD 50 bn per year. In the waste treatment sector, the investment needs are estimated at about USD 14 bn every year until 2025. For West Africa alone, the annual maintenance and development needed in the urban infrastructure for 110 million inhabitants would increase from about USD 1.8 bn per year in 2007 to a peak of USD 5.5 bn in 2020.

Given these figures and considering the vast array of investment needs in local governments, estimating main-

tenance and development costs of urban investments at about USD 200 billion per year over the next 25 five years for the developing countries seems sensible (one third of the total estimated for public infrastructure by the World Bank).

It must be stressed that this amount is not excessive as it amounts to only 0.4% of World GDP in 2005 (USD 44.645 bn). Annual remittances represent a similar flow, with foreign workers sending about USD 200 billion per year back to their native countries. In comparison, we can mention that this amount is far less than the level of surpluses accumulated in some developing countries: Monetary reserves of the Bank of China reached in 2006 a temporary peak of USD 1.2 trillion.

Table 2
Estimates of Average Density and Built-Up Area per Person for Regions, Income Groups and City Size Groups; 1990-2000.

Category	Average Built-up Area Density			Average Built-up Area per Person		
	1990	2000	Annual % Change	1990	2000	Annual % Change
Developing Countries	9,560	8,050	-1.7%	105	125	1.7%
Industrialized Countries	3,545	2,835	-2.2%	280	355	2.3%
Region						
East Asia & the Pacific	15,380	9,350	-4.9%	65	105	5.1%
Europe	5,270	4,345	-1.9%	190	230	1.9%
Latin America & the Caribbean	6,955	6,785	-0.3%	145	145	0.3%
Northern Africa	10,010	9,250	-0.8%	100	110	0.8%
Other Developed Countries	2,790	2,300	-1.9%	360	435	2.0%
South & Central Asia	17,980	13,720	-2.7%	55	75	2.7%
Southeast Asia	25,360	16,495	-4.2%	40	60	4.4%
Sub-Saharan Africa	9,470	6,630	-3.5%	105	150	3.6%
Western Asia	6,410	5,820	-1.0%	155	170	1.0%
Income Category						
Low Income	15,340	11,850	-2.5%	65	85	2.6%
Lower-Middle Income	12,245	8,820	-3.2%	80	115	3.3%
Upper-Middle Income	6,370	5,930	-0.7%	155	170	0.7%
High Income	3,565	2,855	-2.2%	280	350	2.2%
City Population Size						
100,000 - 528,000	5,955	4,810	-2.1%	170	210	2.2%
528,000 - 1,490,000	7,620	5,970	-2.4%	130	165	2.5%
1,490,000 - 4,180,000	6,870	6,040	-1.3%	145	165	1.3%
More than 4,180,000	5,860	5,405	-0.8%	170	185	0.8%
Global Average	6,485	5,470	-1.7%	155	185	1.7%

Source: The Dynamics of Urban Expansion, Shlomo Angel, Stephen C. Sheppard and Daniel L. Civco, Transport and Urban Development Department, the World Bank, 2005.p 56.

However, this assessment is probably a low estimate as it would be necessary to take into account the urban growth pattern, which might deeply impact the costing of urban public infrastructure, (i.e. due to urban sprawl) and is thus of concern to local governments from developed countries.

- Urban Growth Patterns Deeply Impact Investments' Needs and Costs

This urban sprawl has been recently analyzed in a sample of 90 cities. According to conservative estimates, average urban densities declined at the annual rate of 2.2% in developed regions and at 1.7% in developing countries from 1990 to 2000. If this tendency is to go on, by 2030 the developing-country cities will triple their urban land area (from 200 000 km² in 2000 to 600 000 km² in 2030) while their population doubles. There seems clearly no commitment being made towards a compact city policy – the classical debate about choices to be made between a model of a European compact city type like Barcelona and an antonymic prototype such as Atlanta seems not to have taken ground yet.

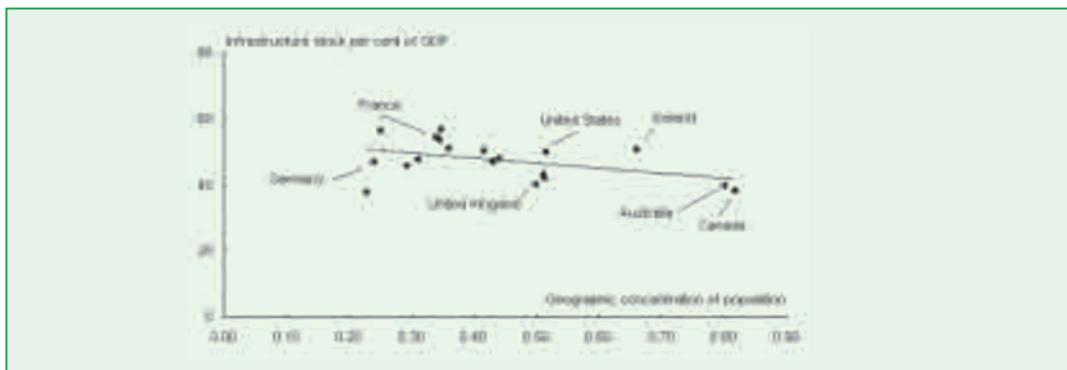
Nevertheless, compact urban development results in lower infrastructure costs (especially for water and sewers) and lower op-

erating costs because the needed infrastructure (hard services such as local streets, sewage collection lines, water distribution pipes, storm drainage systems) is linearly related. Scattered development can be as much as 70% more costly than equivalent forms of compact development (Duncan et al. –1998).

At the national level, this relationship between population concentration and public infrastructure has been researched. For the OECD high income group of countries, where level of infrastructure provision is similar, the greater the population concentration, the lower the infrastructure stock as a proportion of GDP. Many factors contribute to the size of the infrastructure stock for any particular country; population concentration is said to explain about 20% of the change in infrastructure stock.

This urban sprawl implies rising cost for city investment and maintenance of city infrastructure especially if not adequately tackled and planned. As it is more expensive to provide trunk urban infrastructure in built-up areas (especially in areas developed by the informal sector) than to provide these services before building takes place, a key aspect of this expansion is planning.

Finally, this urban sprawl bears also environmental consequences, such as global



Graph 9
OECD Countries:
Relationship between Geographic Concentration of Population and Public Infrastructure Stock, 2000.

Source: Kamps (2004) for infrastructure stock as a proportion of GDP and OECD (2005) for the geographic concentration index. The Groningen Growth and Development Centre (2006) data base was used for high-income countries based on GDP per capita in purchasing power parity terms. Countries included are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and United States.



warming as it implies higher air pollution, excessive energy use and increased greenhouse gas emission, which in turn may result in additional public investment needs.

We have been here focusing on developing countries urban infrastructure needs. However, the significance of urban infrastructure investments to be realized in developed countries is proportionate to the decline in public investment that has been globally observed in these countries over the last decades in these countries, apart from some exceptions. Upgrading aging urban infrastructure would be needed in many countries, and the strong emerging demands expressed by the citizens towards greener and healthier cities will most certainly raise the level of investment needed. Nonetheless, access to finance for these local governments is to some extent less problematic than for their sister cities in the South.

Conclusion: Urgent and massive investment needs are required in cities, as well as careful planning, if the consequences of ongoing urban growth are to be tackled. Population concentration and the urban pattern growth is not only a local government issue, but a national concern, as it directly defines the needed level of public infrastructure.

All local governments are facing two key challenges, magnified by the rapid urbanization growth: how to meet increasing demand for new and upgraded infrastructure on the one hand; and how to pay for the needed infrastructure on the other hand. The problems in meeting these challenges are probably more significant than ever. What are the funding options available?

2. FUNDING OPTIONS AND GAPS: IDENTIFYING THE MISSING LINKS

1) Why Should Local Governments Finance Local Public Infrastructure?

Considering the benefit area of several government goods and services, local governments are best positioned to carry out local infrastructure investments. For many government services such as street lighting, water provision, sewage collection and treatment, that affect local residents, local governments have a better knowledge than the central governments of the local situation and their citizens' priorities. Decentralization enables more variety, experimentation and innovation in service provision. In contrast, central provision is likely to lead to uniformity.

These arguments plead for a substantial degree of local governments' autonomy in

infrastructure and service provision. They are based on the principle of local governments' accountability and responsibility to their electorate, for both the expenditure they incur and the revenue they raise to finance it.

Local governments have constant pressure to provide or facilitate the delivery of essential infrastructure services, yet they have often only modest and sometimes no means to fund it, especially in developing countries. According to data collected in *Local Governments in the World, Basic Facts on 80 Selected Countries*, a joint UCLG-DEXIA study, local governments total expenditures and local government capital expenditures amount respectively to 1.9 % and 0.4% the GDP on average in the low income countries studied (against 10.9% and 1.5% of the GDP in the high income countries studied).

1. Provision of pure public goods. Such goods may be defined by two characteristics:

- their consumption is non-rival—i.e., consumption by an individual is not in competition with consumption by someone else;
- their consumption is non-excludable—i.e., it is not possible to exclude someone from their consumption because, for example, he or she did not pay for the service.

Among typical local services, the best example of a public good is perhaps street lighting. «Using» light produced by a streetlight does not place a person in competition with someone else who may benefit from the same light. It is also hard to imagine that the lamp would be switched on only for those who paid a fee for street-lighting while others were excluded from consumption of the service. Such an example serves to demonstrate how the market is not capable of regulating the provision of public goods.

2. Several typical local services such as water provision, sewage collection and treatment, central heating and gas supply are natural monopolies. Natural monopolies can be defined as sectors in which a single provider can produce a lower unit cost (for technical reasons) than two or more providers could. Here too, market regulation is not efficient and public intervention is required.

Box 1
Justification for
Local Public
Spending – the
Provision of Local
Public Goods.

3. Externalities. By classic definition, externalities are positive or negative effects of transactions affecting actors who have not been directly involved in these transactions. Let us try to imagine a specific example of this in a local community: the provision of fire protection. Consider the consequences if this service was provided by the private sector only to those who paid a subscription. It may happen that house A, whose owner has not paid for fire protection, is on fire. However, should the fire brigade not intervene, there may be negative effects—the externalities—for neighbours who have paid their subscription. Obviously, the fire brigade should stop the fire because of the externalities.

A second example is environmental protection. Let us think about Mr. B. who burns old tires in his back-yard. This activity has negative effects that go well beyond his own property, affecting his entire neighbourhood. In both cases, public intervention and the provision of some services from local budgets will be more effective, since it allows for internalization of externalities.

4. Some authors argue that there are also merit goods, which legitimize public financing and intervention. Society may believe that the provision of certain services is so important that we should not allow total freedom for individuals to determine their own level of consumption of those services. Public education is a good example. If society agrees on the importance of educating all children to a high standard, then the decision on whether or not to send children to school becomes a social, not an individual decision. Consumption of these services can be stimulated by public provision, even if they are not public goods by their nature.

Source: Foundations of Fiscal Decentralization, Pawel Swianiewicz.

2) Overview of the Current Financing Options and Their Limits

The broad funding approaches for financing local government public infrastructure traditionally include government borrowing, taxes, intergovernmental transfers and grants from the central State, user charges, producer levies such as development charges and the establishment of special entities for infrastructure provision (publicly owned utilities or Public Private Partnerships like concessions).

- Intergovernmental Transfers and Local Taxes

Mainly constituted from local taxes and central state transfers, budget sources, are often insufficient for financing local public infrastructure needs. Budget revenues are primarily used to cover recurring

costs and expenses of the local governments. As a matter of fact, when resources are scarce or insufficient, for a structural reason or a reason pertaining to a conjuncture, capital expenditures and investment in local public infrastructure are always the first to be downsized. In francophone Africa, for instance, recurring expenses are recorded to amount to 80% or 90 % of the total budget of the local authority, leaving capital expenditures the remaining part. In Germany, over the recent years, the financial crisis affecting local governments compelled municipalities to reduce drastically their capital expenditures and investments.

Given the lack of local taxes, intergovernmental transfers play a key role in financing local capital expenditures in many countries. In many countries however, local governments often report the non transparency, irregularity and unpredictability of intergovernmental transfers

as a major impediment to infrastructure planning and financing. In some countries transfers are overwhelmingly made in the form of tied grants (encouraging expenditures on national priorities) and a better mix with unconditional grants (at the discretion of local governments) would have positive effects. Furthermore, intergovernmental transfer systems are not systematically setting up perequation mechanisms providing funding to the poorest local governments (offsetting the so-called horizontal imbalance among local governments). In addition, as referred in the GOLD report, intergovernmental transfers have often undermined local governments incentives to raise own revenues.

In view of future needed reforms, the design and implementation of sound fiscal decentralization frameworks should care-

fully consider the effective and stable allocation of financial resources at the local level and the interrelation between local taxation and transfers.

- Public Private Partnership (PPP):
Have private firms
Co-Finance or Co-Invest in Urban
Public Infrastructure.

PPP was seen in the 1990s as a way for the Central State to step back from infrastructure funding and management. However, several crises (like the Asian crisis of 1997-1998, Argentina in 2002-2003) have deterred private investments in public infrastructure and especially at the local level. Private investors have limited their financial exposure in urban private participation in infrastructure and tend to demand very high guarantees, preferring to focus on

The fiscal power of local communities in Africa is very limited, even more so in those countries with French administrative tradition than in those with British administrative tradition. The product generated by local entities is generally very weak due to the lack of adaptation of certain taxes to the economic and social reality and also because local administration is not very strong evaluating and recovering fiscal income. When the State assumes these functions, normally local communities are not taken into account in the fiscal chain, especially in French speaking countries. Even though urban centers enjoy a better situation, that of rural communities is still a big problem.

The division of fiscal funds and State controlled financial transfers tend to be spread as financing modality of local budgets. However the division terms of fiscal funds are very often not favorable to local communities, apart from the fact that the transfers are not regular. The effectiveness of the transfers is more related to circumstantial situations, than to the legal rules. In some countries, the Constitution instructs to divide resources between the State and the local communities prescribing the transfer of a precise part of the national income to the latter. But the international context of structural adjustment policies limits the State capacity in terms of financing transfers to local communities. Moreover, certain countries don't have any organized transfer system and, as a result, the flow of funds is vulnerable to political hazard.

With the exception of local communities of South Africa and North Africa, local communities of other countries of the continent have no experience at all on how to reach international loans and therefore, their access to them is very limited.

The combination of all these factors lessens the finances in local public entities (almost always inferior to 5% with the exception of South Africa, Nigeria, Uganda and Zimbabwe where this figure varies from 5 to 10%).

Source: GOLD report, UCLG.

Box 2
Local Government Budget Revenues : The situation in Africa.

high return investments and revenue generating projects where the expected future cash flows are convertible in foreign currency (international airports, telecommunications...).

Annual private investments in PPP are rather irregular, are focused on a handful of countries in Latin America and East Asia, and do not serve primarily urban infrastructure: only about USD 60 bn over the 1984-2003 period have been spent for local government infrastructure (about 10% of total PPI). Therefore, if we relate this figure with urban infrastructure needs (about USD 200 bn), it is highly unlikely that PPP could radically help local governments finance their trunk infrastructure.

However, this data focuses on transactions involving international investors, thus the

useful role played by local private investors, even if limited in terms of absolute amount of financing, should not be underestimated. A number of local governments have regularly reported on how they successfully set up innovative public private partnership with local businesses (for instance street lighting in Nairobi) or NGOs at the community level.

Interestingly, one of the reasons advanced for such a low inflow of private funding is the significance in practice of public subsidies to the provision of urban services such as piped water, which introduces uncertainty and risks for the private partners.

More fundamentally, PPP and PPI mitigated results are often linked to the institutional weakness of governments as

Graph 10
Total Private Participation in Infrastructure and Urban Private Participation in Infrastructure (PPI) in Developing Countries.

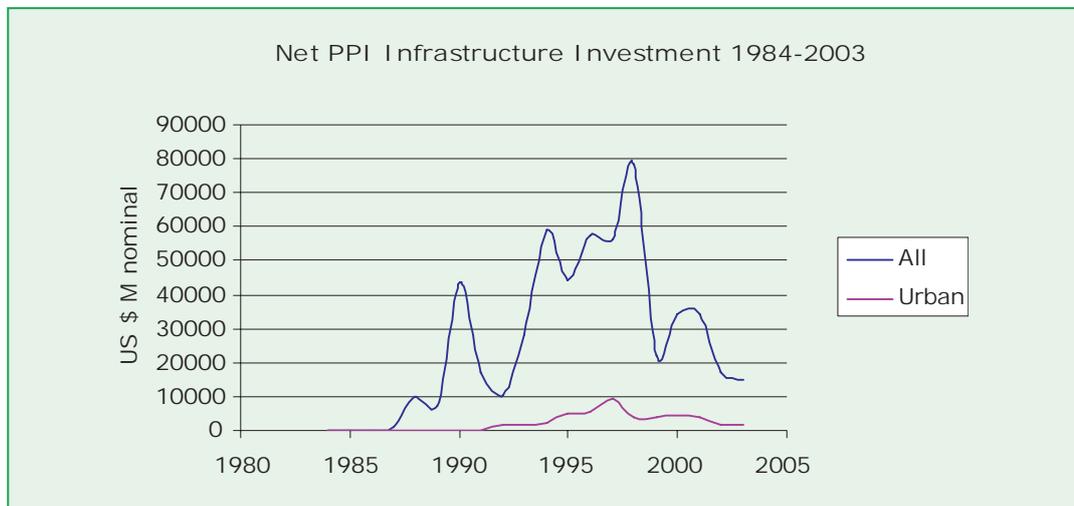


Table 3
Regional Break-down of Total PPI and Urban PPI in Developing Countries¹.

\$ M nominal	EAP	ECA	LAC	MENA	SAR	SSA	Total
All PPI	157,867	77,503	273,678	22,474	37,943	28,469	597,934
% of Total by Region	26%	13%	46%	4%	6%	5%	100%
Urban	26,493	2,796	24,581	5,373	423	1,600	61,266
Urban as a % of Region Total	17%	4%	9%	24%	1%	6%	10%

Source: Urban Infrastructure Finance from Private Operators: What have we learned from recent experience? Patricia Clark Annez, World Bank Research Working Paper 4045, 2006.

1. EAP stands for East Asia Pacific, ECA for Europe and Central Asia, LAC for Latin America and Caribbean, MENA for Middle East and North Africa, SAR for South Asia and SSA for Sub-Saharan Africa.

well as inadequately developed and /or inadequately enforced frameworks.

- Have National or Local Public Enterprises/Utilities Finance and Develop Local Public Infrastructure:

In many countries, these public utilities have provided and are providing significant services to the expanding urban center (usually in water, sewage, and road sectors). However, many local governments criticize National Public Enterprises' performance: highly dependent on nationwide priority setting and budget, they fail to integrate local governments' demands and needs, as well as a wider cross-sector investment strategy. Within this context, it is extremely difficult in practice for a local government to ensure that the utilities development strategy fits to the urban planning and own local development strategy.

Moreover, pricing of services, which is a sensitive political issue, is rarely re-

flecting the real costs of operation and maintenance (O & M). For instance, for the water sector, this is a key feature which leads directly to and perpetuates high level of public subsidies, meaning that the service is financed in fine by the tax payer and not the user.

Local and National Public Utilities often set low user fees and tariffs (below operating costs), or may be required to do so by national rules and regulations. Although this is justified for social reasons (while at the same time subsidizing those who can afford to pay full cost recovery tariffs), in practice, this greatly limits the extension of the service to other citizens, especially in developing countries where public subsidies are insufficient to finance development of the infrastructure network. As a result, it is usually the poorest who find themselves durably excluded from access to these basic services. Local and national utilities appear in many cases more accountable to the national or local

By Income	Percentage of utilities whose average tariffs appear to be		
	Too low to cover basic O&M	Enough to cover most O&M	Enough for O&M and partial capital
HIC	8	42	50
UMIC	39	22	39
LMIC	37	41	22
LIC	89	9	3
By Region			
OECD	6	43	51
LAC	13	39	48
MENA	58	25	17
EAP	53	32	16
ECA	100	0	0
SAS	100	0	0

Table 4 Probable Degree of Cost Recovery of Water Utilities².

Source: Water, Electricity and the Poor, Who Benefits from Utility Subsidies? Kristin Komives, Viverin Foster, Jonathan Halperin, Quentin Wodon, with support from Roohi Abdullah. Directions in development, The World Bank, 2005³.

2. HIC stands for High Income Countries, UMIC for Upper Medium Income Countries, LMIC for Lower Medium Income Countries, LIC for Low Income Countries, SAS for Sub-Saharan Africa.
3. It must be stressed that the data provided at least for ECA must be older than 2005, as several price reforms took place in many East European countries these last years.

government than to their customers and moreover to the ones that are not yet clients. Finally, within this context, the poorest deciles of the population remain unserved and often have to pay, on their own, a higher price per unit for the same public good.

As a consequence, in order to finance the required infrastructure, public utilities will often need to reform their operations, balance accountabilities and propose pricing adjustments that allow not only to maintain the infrastructure but also to develop it. A system of social vouchers, subsidized by local or central government might be established to support the poorest citizens. However, despite these long lasting efforts, swift and significant improvement of the infrastructure coverage, as shown in the water sector, will predominately depend from subsidies and therefore rely on national and local budget capacities.

- Land and Asset Management as a Way to Finance Local Public Infrastructure:

In many countries, local governments have historically developed land management tools. For instance, they usually required developers to provide or pay for on-site infrastructure such as streets, lighting, sidewalks and other public facilities related to the new urban operation. A modern and more refined tool is nowadays applied by several local governments. They levy development charges, to cover part of the off-site infrastructure costs associated with new development (for instance, a portion of an additional pump for piped water that will cover the new area developed). Based on the principle that the new comer should support the access to developed services and infrastructure costs, these charges are considered as a good tool to support local governments in financing extension of public infrastructure. However, many pre-

requisites question their practicability: not only an inventory or cadastre of the land and properties is necessary, but also a clear overall strategy, clarifying the patterns and modalities of urban development. Time, money and political will at local and central level are altogether necessary to pursue the establishment of such a tool. Improving urban land management is to be promoted but may often require long and painful reforms, for which political commitment is lacking.

Property or asset management is another funding option. Through lease, rent, concessions or sales, local government will use its assets to finance public infrastructure. This has been widely used but unfortunately often as a way to cover recurring expenses and operations and not infrastructure. Asset management implies also capacities and vision. A regular update of the inventory of the municipal assets and values, as well as a global strategy (as opposed to ad hoc opportunities) would be needed. As for land management, this necessitates medium to long term reforms. Furthermore, these resources may not really match the immediate investment challenge.

- Funding through Development Banks and ODA.

Multilateral financing institutions do not currently lend directly to local governments, except the European Bank for Reconstruction and Development and the Inter-American Development Bank, but are now in a slow process of reviewing their lending operations and urban strategies. Even when channelled through central state, lending towards urban infrastructure remains today marginal. At the World Bank Group, only 8% of the total lending of USD 22.3 bn in 2005 has been channelled towards urban development and infrastructure (USD 1.9 bn).

Given the importance of available financial liquidities and savings especially in some developing countries, and a foreseen increased competition in lending for public infrastructure (namely with the establishment of the Bank of the South but also with increasing financial assistance from countries such as China or Korea), there are opportunities for development banks to develop a more proactive strategy towards local governments and local public infrastructure.

Donors also tend to commit themselves to the urbanization challenge, but the amount of ODA, stabilizing around

USD 100 bn in total, and about USD 60 bn since 2000 for development programmes excluding Afghanistan and Irak, is still barely directed to local governments. When targeting local public infrastructure, donors have been developing community development funds, which allocate funding to small scale investments identified through community participation, outside from regular local governments operations (often leading to newly built infrastructure without planned operation and maintenance). Within this context, donor programs might be considering the positive results registered in city-to-city development programmes.

Access: Loans are issued with sovereign guarantee, so may often imply that a local government is well-connected with the relevant Ministry or Department.

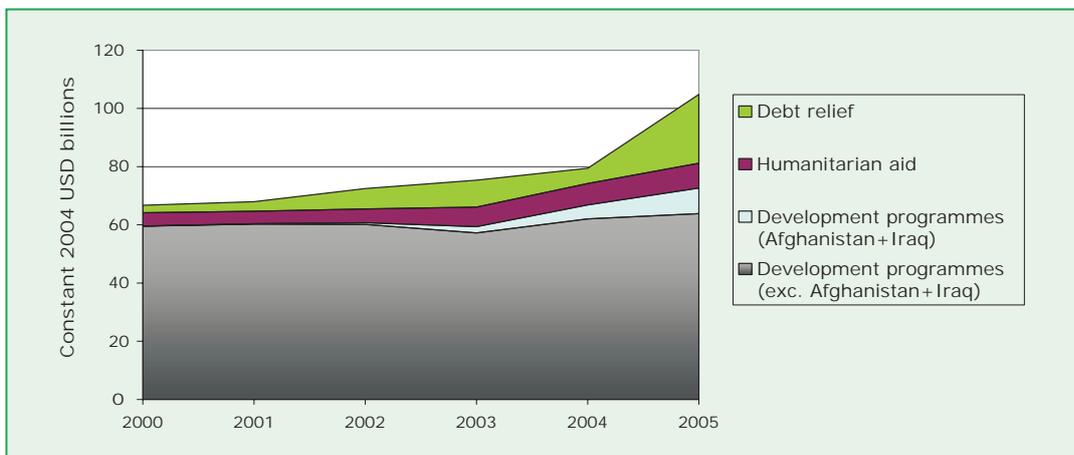
Long negotiation process: Often three years of negotiations before lending becomes effective and loan funds approved, if not disbursed

Project Preparation Process: Loan preparation and justification documents are lengthy and costly to prepare, relative to the size of the loans, particularly for small and medium-sized projects

Capacity building and technical assistance: Very often externally provided, does not build sustainable capacity and local know-how in project preparation skills (pre-feasibility / feasibility studies, bidding documents, etc.)

Who is doing what?
EBRD: some direct lending to local governments, without sovereign guarantees
International Finance Corporation (IFC)/World Bank: Municipal Fund, which concluded two deals (Johannesburg and Mexico) in three years, a new Sub-sovereign Programme, following the same operational process, is succeeding to the Municipal Fund.

Box 3
 What are Multi-lateral Financial Institutions doing for Local Governments?



Graph 11
 Components of Net Development Aid Committee Official Development Aid, 2000-2005.

Source: ODA Report, 2005.

In a context of urban expansion, local public infrastructure and local governments should be considered as a key area for enhanced lending, technical assistance and grants.

- Local Government Debt: Linking Domestic capital to Local Public Investment.

«Since the 1980s, municipal loans amount to around € 12 bn per year. The biggest borrowers, outside the G7, are South Africa, Bulgaria, Poland, Bulgaria, Hungary, Estonia, Brazil, Columbia, China, Slovakia and Ukraine» (AfD, 2007). Local public borrowing is significant in developed countries and in a few countries in transition, while it is not considered as a financial tool for local public infrastructure in a vast majority of developing countries' local governments.

In many developing economies, especially in Asia but not only, liquidities and domestic capital are available but tend to be invested abroad instead of supporting investment in local public infrastructure. Mechanisms to tap private savings to fund local public infrastructure should be encouraged, however this link is not easy to set up as it requires an efficient national credit market and banking sector, collecting on one side the resources (private savings, firms or pension funds liquidities, remittances, etc.) and investing on the other side into local public infrastructure (through loans or bonds to local governments or private firms).

The speed of financial and capital market development in individual countries may be lengthy and many national government established specific public banks or funds to provide finance to local public infrastructure during this transition period. These public financial institutions often have by law access to cheap sources of liquidities (personal savings, state grants...). Today, in developing countries, linking domestic capital to local public investment requires an urgent

rethinking of financing schemes for local government and an analysis of the positive experiences, in order to explore and extend this new approach to local finance. Rather than solely relying on the preparation of municipalities for an hypothetical access to the capital market, there is a need to accelerate reforms and develop the financial tools available to effectively provide credit to local governments.

In any case, no local credit market will develop if local governments are not entitled to mobilize and receive regular and sufficient inflow of resources, enabling them to repay the debt. National governments have a decisive role to play in improving fiscal decentralization frameworks, which in turn will facilitate the link between domestic capital and local public investment.

Conclusion: From a local government perspective, a spectrum of instruments is needed to finance local public infrastructure and no unique solution can be put forward, even if one particular instrument is privileged by the development community. Moreover, some instruments are not efficient unless specific pre-conditions and requirements are met, which in many developing countries is not the case. Therefore, these options should be appropriately evaluated and prioritized in the context of particular countries.

However, time is of the essence and options which require lengthy national reforms are likely not to be implemented before the urbanization explosion has materialized. Furthermore, the scale of the local public infrastructure needs implies a radical and swift change in the level of funding provided to local governments. In order to finance massive local public infrastructure needs, the crucial and sustainable option consists in enabling local government to be creditworthy and to borrow, which implies actions to be taken on the demand side (local government) and supply side (financial markets, banks, and donors).

**LOCAL GOVERNMENT FINANCIAL
AUTONOMY FOR URBAN
INFRASTRUCTURE INVESTMENTS**

1. EFFICIENT FISCAL DECENTRALIZATION FRAMEWORKS GENERATE SWIFT AND MASSIVE INVESTMENTS IN PUBLIC INFRASTRUCTURE

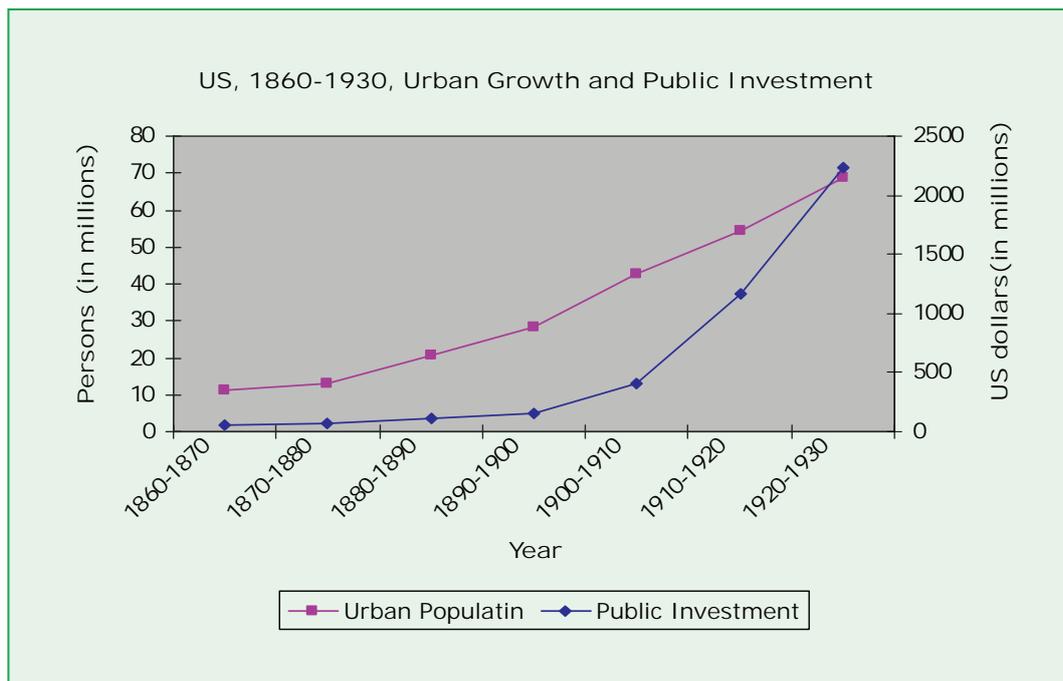
1) Historical and Empirical Evidence from Past Rapid Urban Expansions and From Current Developing Countries

Whenever national governments have made local governments stronger, investment has improved and national GDP has risen. Many countries, faced with a rapid urbanization growth, made the choice to rely on local governments for providing local public infrastructure by allowing them sufficient revenues and the possibility to borrow. Following these decisions, urban public investment increased, which in turn, benefited national growth.

- USA, XIX century: Local Government Debt Provided the Infrastructure Required by the swift Urbanization of the Country

One historical example of such a decisive and positive choice is given by the rapid urbanization that occurred during the second half of the XIX century in the United States of America. While the urban population increased from 10 to 70 million from about 1860 and 1930 (which is a 10% annual rate of increase over the period), total public investment soared through the efforts of local governments.

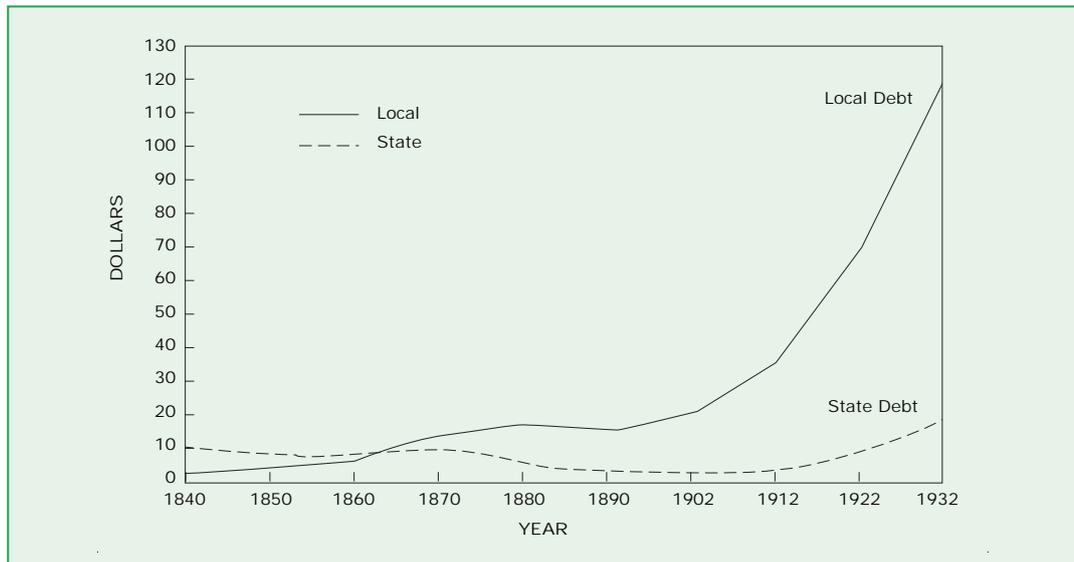
American local governments were allowed to borrow and they filled the infrastructure



Graph 12
USA, 1860-1930,
Urban Growth
and Public In-
vestment.

Source: Research from Juliana Pigey and Naweem Jawaid, The Urban Institute.

Graph 13
Evolution of Per Capita State and Municipal Debt in the USA, 1840-1932.



Source: Perspectives on Urban Infrastructure, Commission on Behavioural and Social Sciences and Education, Committee on National Urban Policy, National Research Council 1984. Based on Data from A.M Hillhouse, 1936, Municipal Bonds: A Century of Experience, New York: Prentice-Hall.

investment gap that States did not tackle. Local governments massively invested in streets, water supply, sewers, school, street lighting and also transport networks (railroads). The significance of their role in urban infrastructure is clearly demonstrated by the significant increase of local debt, which amounted to about USD 14 bn in 1930, accounting for a predominant proportion of public investment.

- South Africa: 1994 –to Date: Enabling Local Governments to Finance Urban Infrastructure Through a Sound Fiscal Decentralization Framework

Since the first democratic government took office in 1994, urban infrastructure has steadily improved (access to piped water, sanitation, electricity, etc.) in relation to the empowerment of local governments, held responsible for a vast array of infrastructure. «The broad goal in financing municipal infrastructure, both urban and rural, has been to create autonomous, financially stable, self-financing municipali-

ties able to borrow from the private financial sector on a sound basis. A parastatal development bank, the Development Bank of Southern Africa has lent to municipalities alongside the private sector. However, the emphasis has been on subsidization via the grant system and not through the provision of cheap loans»⁴, which seems to have enabled even poorer municipalities to invest into basic infrastructure. Besides significant own revenues (mainly property tax and user fees), local governments are entitled to fiscal transfers from the state, and especially capital grants. Recently, the latter have been simplified in a single unconditional capital grant, which leaves local government more flexibility in selecting their infrastructure projects.

- State of Tamil Nadu, India, Devolution since 1997: Improved Fiscal Decentralization Schemes Enable Local Governments to Respond to the Urban Challenge

In India, while transfers from the federal State to the member States have been

4. Philip van Runeveld, Mobilizing Urban Infrastructure Finance within a Responsible Fiscal Framework, South African Case, WB Policy Research Working Paper 4042, November 2006.

	Population			Growth Rate Urban	Level of Urbanization
	Total	Rural	Urban		
	in million			%	%
1961	33.7	24.7	9.0	22.6	26.7
1971	41.2	28.7	12.5	38.6	30.3
1981	48.4	32.5	16.0	28.0	33.0
1991	55.9	36.8	19.1	19.6	34.2
2001	62.1	34.9	27.2	42.8	43.9

Table 5
Tamil Nadu swift Urban Growth.

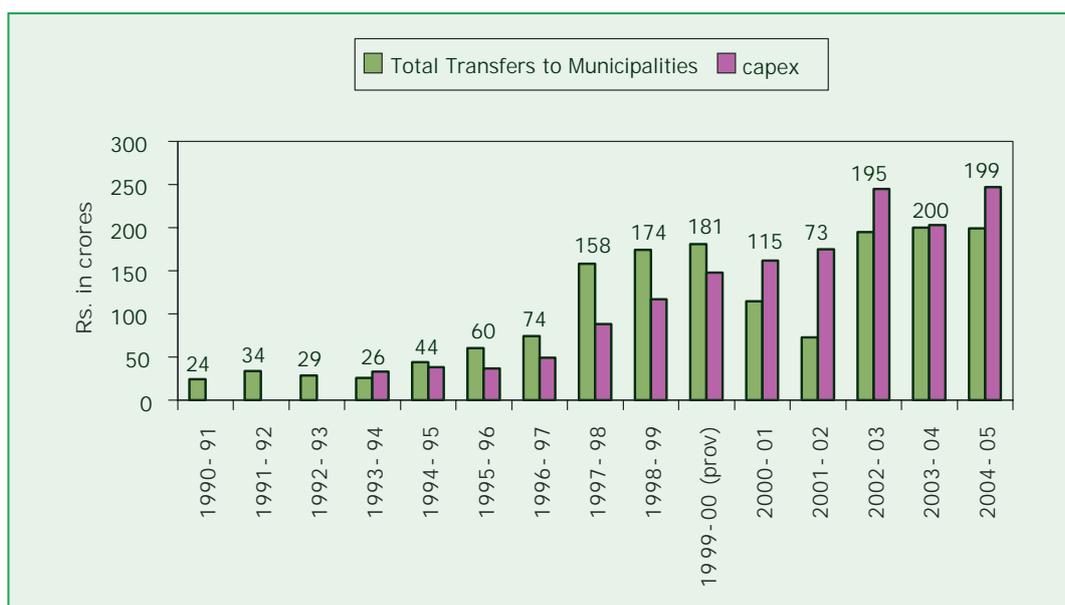
Source: Census of India, Analytical Note on TNUDP and Its Impact on Municipal Capacities, R. Krishnawamy.

fairly laid out, the situation of local governments varies from one State to another. Remarkably, in rapidly urbanizing states, like in Tamil Nadu, where about 50% of the population is urban, there is a global but still uneven trend towards more efficient fiscal decentralization frameworks, which in turns impacts positively on urban infrastructure investments.

states to local governments, the State of Tamil Nadu decided, in 1996-1997, to share a part of its State's tax revenue with urban local governments and to develop rational, predictable, formula based fiscal transfers from State to Cities. This predictable flow of money had a direct and rapid impact on the amount of capital works executed by local governments.

Following the 74th amendment to the Constitution in 1992, which promoted elections at the local level as well as the improvement of financial transfers from

The funding of urban infrastructure has risen considerably, especially in basic environmental infrastructure. These revenue streams have also generated inter-



Graph 14
Transfers to Municipalities and Capital Expenditure, in Crore (1 Crore= 10 Million) Indian Rupis (RS) (1 USD = 40 Rs.).

Source: Empowering Cities State Level Actions – The Tamil Nadu Experience, S. Malathi, Powerpoint Presentation WUF 3.

est amongst banking institutions and investors and local governments have had an increased access credit to finance for their infrastructure.

- Lessons learnt: Developing the Financial Autonomy of Local Governments Enables Them to Respond to the Urban Challenge

In these examples, as in many countries where decentralization has been effectively promoted, a well known virtuous process is at play. Local governments vested with sufficient, regular and predictable revenues are made creditworthy and can access debt to invest in their local public infrastructure. The central step forward is the decision taken to provide finance to and let local governments have discretion over financial resources, which is a key condition for the effective realization of the added value usually expected with decentralization.

According to many economists, local governments provide greater effectiveness and efficiency because decision-makers are closer to the results of their own decisions, which is helpful in predicting the real effects of decisions to be made (closeness to results supports effective allocation of resources). Additionally, local gov-

ernment enables a better match of policies with local conditions and preferences (policies are closer to voters' preferences); local citizens accept to pay taxes and fees for a service that they need and demanded.

To achieve this greater effectiveness, financial autonomy must be granted to local governments: local governments need some control over their resources and responsibilities. Two indicators are usually considered as essential for financial autonomy:

- The level of own revenues (taxes and fees) to total local government revenues. When local government finance relies for about 75% on central funding, as is presently the case in the UK these days, it generates gearing issues (local government cannot adjust their revenues to their preferences) and accountability problems (central accountability bundles too many issues together) and impacts negatively on local democracy (low turnout).
- The establishment of predictable and fair intergovernmental transfers, with a good proportion of grants that are not earmarked (local governments can channel it where they think this is the most useful) and with an equalization

Box 4
Where do Local Government Revenues come from?

There are three major sources of revenues:

1. Own revenues of local governments: Local taxes, fees for services provided, revenues from local government property...
 - They are revenues allocated to local governments unconditionally, in full and for an undefined period,
 - They are related to the economic base,
 - Local government has at least some discretion to decide upon these categories or revenue.
2. Transfers from the central budget in form of grants:
 - General purpose grants, which can be used freely for any purpose,
 - Conditional grants, which can be spent only for a purpose defined by the State.
3. Borrowed resources: bank credits, municipal bonds...

Local authorities need substantial tax power to avoid the problems of gearing whereby, say, a 10% rise in local taxes leads to only a 2.5% increase in local spending – as is the case in the average English local authority. Voters do not face this situation with anything else they spend money on, and may well be confused.

If local authorities rely substantially on grants, or even on taxes whose rates they cannot set, then they can spend the money inefficiently and yet blame the resulting poor services on under-funding.

Local politicians, bureaucrats and voters may take more care with money that is raised locally at rates they set than with money that has been given to them or that is raised at rates outside their control.

When a government pays grants, it may well feel that it should control how grant receipts are spent, as it is accountable to its national taxpayers for this money. The costly mechanisms of control that it will put in place would not be needed if local authorities were largely responsible for raising their own taxation. High central funding may also be a barrier to meaningful development of freedoms and flexibilities.

Source: Options for Local Government Finance: An Economic Approach, A Report for the Country Councils Network, David King and Peter Watt, October 2005, County Background.

grant supporting the poorest local governments in providing basic services.

It must be stressed that some countries introduced in their constitution the right to fair intergovernmental transfers and the connexity principle (no delegation of function to local government without adequate financial transfers) to avoid central

state irregular and arbitrary intergovernmental funding, which has devastating effects on local public investment.

Shifting investment responsibilities together with financing authority to local governments is the best way to tackle urbanization growth. However, providing such a framework is a permanent challenge.

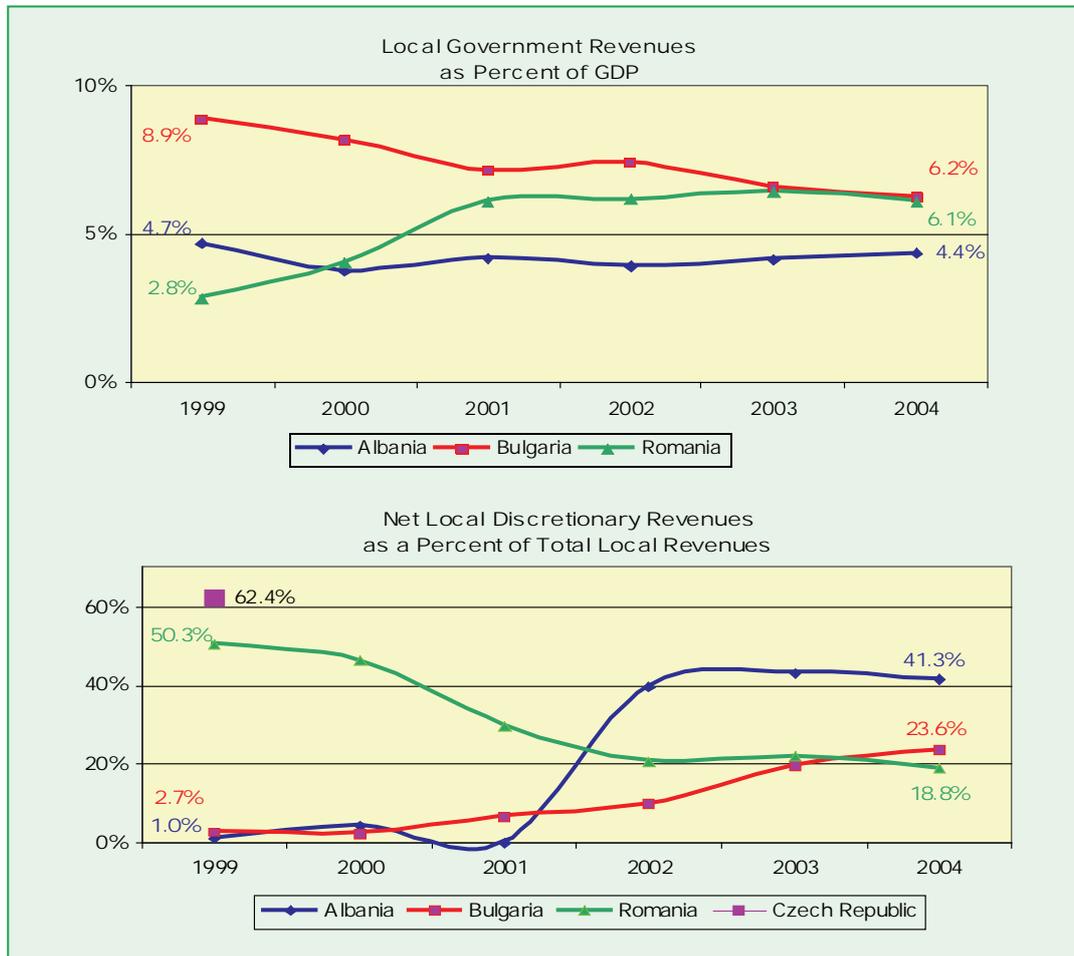
Several international documents describe in similar terms the financial principles for an efficient decentralization. Following the European Charter of Local Self Government, established in 1985, the International Guidelines on decentralization and the strengthening of local authorities, over which a general consensus amongst the State members of the Governing Council of UN-Habitat has been reached, displays a common set of principles to be respected in the establishment of fiscal decentralization frameworks:

- Commensurability Principle: Local governments should be vested with financial means in proportion to the responsibilities provided for by the constitution and the law. This implies that the vested financial means shall be dynamic (of 'buoyant nature') and diversified (to avoid a dependence toward one single source of revenue) to follow the increasing costs of the carried responsibilities.
- Right to Own Source Revenues: Local governments must have freedom to set and implement own taxes and fees. Own sources support local government accountability towards the local population and exerts pressure on spending.
- Limited Use of Conditional State Transfers: earmarked grants from the Center should be limited to guarantee local governments more flexibility in the use of the grants.
- Solidarity Principle: financial equalization mechanisms must be established in order to support poorer local governments.
- Right to Borrow for Infrastructure Financing.

Box 5
Intergovernmental Transfers versus Local Taxes: Why Local Government Authority over Financial Sources Matters?

Box 6
International Declarations Describe the Financial Requirements for an Efficient Decentralization and Appropriate Financial Autonomy.

Graph 15
Local Government Revenues and Discretionary Revenues as a Percent of GDP and Total Local Revenues in Albania, Bulgaria, Romania, 1999–2004.



Source: Francis J. Conway, Juliana Pigey, The Urban Institute.

2) Developing Efficient Fiscal Decentralization Frameworks is a Permanent Challenge

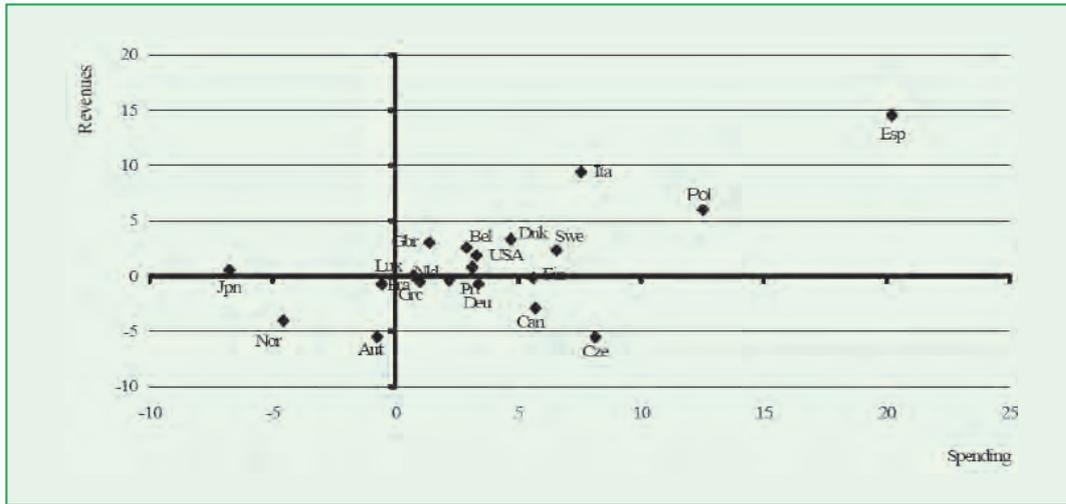
- Assessing Local Government's Financial Autonomy is a Challenging Task

Measuring the level of discretion that local governments have over financial resources is not immediately understandable from such an indicator as the ratio of local government revenue over GDP. Analyzing the revenues over which local governments have some discretion (by setting the rates, by defining the bases, etc.) provides a more accurate perspective on the reality of the financial au-

tonomy at play. The following comparative study over three countries (Romania, Bulgaria, Albania) shows that although local governments in Bulgaria and Romania appear initially to dispose of more funds, they have less decision-making authority over the use of these funds than in Albania.

- Providing Local Governments with Buoyant Public Revenues is a Permanent Challenge

Ensuring the fiscal autonomy of local governments is a never-ending fight. Fiscal autonomy of local governments can be threatened easily and quickly, for instance by replacing local taxes by intergovernmental transfers (like in France and Japan) or by increasing re-



Graph 16
Decentralisation
Ratios, Evolution,
1995-2004.

Source: National Accounts of OECD Countries, Fiscal Autonomy of Sub-Central Governments, OECD Network on Fiscal Relations Across Level of Governments, Working Paper number 2, 2006.

sponsibilities without a proportionate increase of local taxing power. When national government face fiscal constraints (and deficits), the tendency to reduce financial transfers to local government has been widely reported, despite its adverse role on local public investment (see for instance, the situation in Tamil Nadu in 2001 –Graph 12). Another tactic is to delegate to local governments aging taxes which do not generate dynamic revenues, while central states keep the most efficient taxes.

The graph above illustrates a general world wide increase of local spending over the 1995-2004 period in the OECD countries (although this increase has softened in comparison to the 1985-2001 period, with the notable exception of Spain). However, this has not been compensated by the delegation of additional own source revenues but rather by State fiscal transfers to local governments. This general tendency, observed also in Latin America, can prove to be risky for the financial autonomy of local governments, as State fiscal transfers are usually indexed at a rate far below the real evolution of costs.

- Local Government's Financial Autonomy is Threatened by Increasing Inadequacies Between National Taxation Systems and Global Trends

Current and coming hurdles in sharing public resources between central and local governments are often related to inadequate national taxation systems.

Tax competition, fiscal dumping between states⁵ and fiscal evasion to national taxes (like VAT) tend to question current national taxation systems. Multinational companies, which create 40% of the world value is created play with these country tax differences and fiscal paradises to limit their taxation. «The current system of taxing multinational firms relies on separate accounting: firms account for earnings and costs in each location in which they operate. This system generates a large tax incentive to earn income in low-tax countries, and multinational firms respond by earning disproportionate profits in low-tax locations»⁶.

5. For an interesting account on the failure of massive corporate tax incentives and rebate in the US, see *Corporate Income Tax in the Bush Years*, Robert S. McIntyre and T.D.Coo Nguyen, Institute on Taxation and Economic Policy, September 2004.

6. *Reforming Corporate Taxation in a Global Economy*, The Hamilton Project, The Brookings Institution.

Box 7
The Situation in
Africa.

In West African countries, the importance of import and export duties as a proportion of public funds, and their expected fall and end (Doha Round talks, begun in 2001) are likely to further limit the sharing of public revenues amongst central and local governments.

The financial decentralisation of funds to local governments is hindered in Africa by two combined factors related to the national tax setting:

- The first of these is the general low level of taxation (below 17% of GDP in Africa, whereas the levels in Latin America stand at about 20% to 25% and in OECD countries at 40% to 50%). The acute financial crisis in central governments makes it almost impossible for them to transfer to local authorities the funds that they themselves find it very difficult to collect. In addition, the sharing of resources for public initiatives is lower in Africa than in any other region in the world.
- The second factor that makes increasing financial decentralisation more difficult is the importance of import and export duties, which, in most African countries, stand for 50% or more of the state's entire income. The fact that customs duties are typically central government revenue makes it difficult to discuss sharing this source of income with local authorities. The Doha agreements and sub-regional integration have had the effect of bringing down countries' tariffs, with the consequent result of a fall in public revenue collected. Central governments are, therefore, reluctant to share falling receipts while they have no replacement source of taxation that is as easy to collect and generates the same level of income as import and export duties.

Source: François Yatta/ Partenariat Municipal pour le Développement.

Box 8
Tax in a Border-
less World.

«While it is difficult to quantify the overall revenue losses from non-compliance across borders, it is generally regarded in many countries as a serious revenue leakage. Ireland recently collected almost 900 million euros from residents who had been using Channel Island banks to evade Irish taxes. The UK expects to recover £1.9 bn from its recent clampdown on offshore evasion. And a recent report by the US Senate estimated that the Internal Revenue Service could be losing some USD 40-70 bn to tax havens. Left unchecked, it is inevitable that national tax bases will be further eroded, with negative consequences for compliant citizens and businesses, as well as government and the overall integrity of the tax system».

Source: Jeffrey Owens, OECD Centre for Tax Policy and Administration, published in October 2006 in the OECD Observer.

Furthermore, in a context of a developing knowledge economy, there is a perceived sense of a shrinking tax base and obsolete tax systems. The new sources of wealth that emerged with the increasingly global economy seem to be inappropriately taxed. The new firms of the knowledge based economy are characterized by immaterial assets and a lower concentration of equipment and investment, relative to the former industri-

al manufacturers. There is a growing disconnect between this economy and the tax structure, between the profits realized by these firms and success displayed for instance by their capitalization (Microsoft being a good example of this), and the amount of tax effectively paid, leading to the conclusion that taxation of business should be thoroughly reviewed and strengthened.

Within this context, state and local governments are seeking new technology-based revenue streams that would provide dynamic inflows. Local governments in Spain have already made several attempts to tax mobile phones, for the time being in vain. It is however already a reality for many local governments in the US (as in Baltimore and in various Californian cities), which charge a fee or rate on city cell phone subscribers. Governments will increasingly target new technology items as a source for new revenue.

Conclusion: Local governments can become main investors in the required local public infrastructure and contribute to solving the urban challenge, if sufficient financial autonomy is granted to local governments. Ensuring that local

governments have stable and predictable revenue flows, for the main part generated at the local level and under their discretion, proportionate to the functions vested, is the optimal solution for developing local public infrastructure investments.

However, ensuring the financial autonomy of local governments is a permanent challenge, especially in a public finance constrained environment, where all governments' tax bases tend to be eroded by globalization and the knowledge economy. Debate and coordination with the central state will be crucial for developing efficient fiscal decentralization frameworks that will foster urban infrastructure funding.

2. A CALL FOR IMMEDIATE ACTION: RECOMMENDATIONS TO OUR PARTNERS FOR JOINT SUCCESS

On the demand side, in order to boost urban infrastructure investment, a set of recommendations towards local government's partners is suggested. These recommendations must be interpreted and prioritized in each country and implemented in a strategic process.

1) Towards National Government: Improve Intergovernmental Fiscal Relations Frameworks (IGFR)

Central governments are called to:

1. Stop the practice of unfunded mandates (pouring competencies on local governments but not the monies) and guarantee the regularity of flows of finance to local governments and put responsive fiscal instruments in place.

National IGFR framework should ensure predictable, secure and rational revenue sources, proportionate with the expenditures of local governments. National governments should commit to the improvement of the fiscal decentralization frameworks, entitling local governments with sufficient and diversified revenues of buoyant nature. UCLG will engage national governments in reforming IGFR.

2. Closely involve Local governments and national associations of local governments in the design and implementation of this national IGFR framework.

Such frameworks can not be designed and implemented without the close implication of its direct beneficiaries, local governments. National associations of local governments as a key stakeholder must be regularly met by Central state organs dedicated to local finance (Ministry of Finance, Ministry of Interior and other national entities). For example, in the preparation of the annual national budget law, these associations should be consulted.

3. Adapt national and local fiscal tools to new realities, such as knowledge-based economy and globalization:

A key question of fiscal decentralization is the amount and nature of taxes devolved to local governments and local government's role within the fiscal chain. As mentioned, local taxes are often ageing taxes which are not tapping into the new dynamic technology income sources. Assessing which buoyant taxes may become local taxes implies a national assessment of the tax performance and will require a common vision about sharing fiscal revenues. National debate and discussion will be fostered by a diagnosis of the national situation.

Local governments hold very diverse positions in the fiscal chain throughout the world. In the French model, all assessment and collection process is controlled by a central state administration while according to the Anglo-Saxon model, local governments have to a greater extent the possibility to levy and collect taxes. Beyond models, process must be adapted to fit reality and help provide more efficient collection.

Moreover, the review of local and national taxes should also engage an effective coordination at international level in order to limit fiscal evasion and fiscal dumping.

2) Towards Bilateral and Multilateral Financial Institutions: Support Fiscal Decentralization Reform at the National Level

Bilateral and Multilateral financial institutions should:

1. Ensure that local governments benefit from 20% of the revenue made available as a result of debt relief under the HIPC (Heavily Indebted Poor Countries Initiative) and MDRI (Multilateral Debt Relief Initiative).

Debt service savings generated by these two initiatives are estimated to amount to a total of USD 767 M in 2006. UCLG would propose a target of 20%, meaning that at least 20% of these moneys (which is estimated to amount at USD 153 M in 2006) goes to the budgets of the local governments in the 29 countries concerned. This initiative would enable local governments, especially in the swiftly urbanizing Sub-Saharan Africa, to finance their priority investment projects in order to tackle the urban challenge. UCLG suggests discussing with all stakeholders the concrete steps forward for ensuring an effective implementation of this recommendation in the coming year.

2. Strengthen and stabilize intergovernmental flows.

Development banks and donors can play an active role in securing the volume of state transfers directed to local governments especially in the years when the central state is under fiscal constraint and is likely to reduce arbitrarily these grants

to local governments. In order to avoid the negative consequences on infrastructure spending and its destructive effects on investment budgeting and town planning, development banks and donors could coordinate at the national level a support mechanism stabilizing intergovernmental flows over the long term. International inflows to local governments would be provided only when the State would fail temporarily to provide transfers at the level required. UCLG will engage the development community in establishing such support mechanisms.

3. Provide technical assistance to local governments for generating own source revenues in a more systematic way.

Bankers and donors already provide significant technical assistance to central states, national associations of local governments and cities in the field of local finance. However, when the support is about urban infrastructure, the project implementation should require systematically at least 10% of the project funding to be directed towards technical support to own source revenue mobilization, to ensure that future maintenance costs related to the infrastructure will be budgeted for in the local government budget.

4. Set up an observatory on municipal finance with national associations of local governments and central ministries as information system allowing for creditworthiness and accountability of local governments.

Development banks often value financial information as it will help leverage financial markets interest into local government's investments. However, this information should be independently built and supported by the development community at the national level, in order to provide basic information on the status of fiscal decentralization to all stakeholders.

3) Towards Local Governments

Local governments should commit to:

1. Improve the collection of local taxes and fees

It is often noticed that with improved transfers, local governments tend to fail to collect their own revenues. Given the importance of own source revenues, especially in funding local public infrastructure, it is crucial to maintain and optimize own source revenue collections.

Local governments need to engage own source optimization plans to demonstrate their commitment to seek funding for their own infrastructure investment needs. Local assessments, as well as information campaigns, involving all stakeholders at the local level, may also lead to an increase of local tax collection and should therefore be considered and supported.

Effective improvements of collection as well as enhanced budgeting and financial planning will increase local government stockholder's interest. They will also prepare the stage for further agreement with the central state aiming at reforming the IGFR.

2. Commit to high standards of efficient management and transparency, as well as promoting citizen participation.

Various initiatives can contribute to an increased accountability and transparency within local governments. Many local governments have already established interesting practices in this field. Amongst others, the following actions can be listed:

- Issuing regular information and briefing on their financial situation. The more the budget and financial constraints of the

local government are reported and explained, the more understanding and interest will be raised amongst local government partners.

- Strengthening municipal staff capacities (training), especially in finance and investment planning
 - Exploring and testing budget participation initiatives.
3. Strengthen the advocacy role of local government associations and support their training capacities in the area of local finance.

Developing more efficient fiscal decentralization frameworks implies an organized and informed focal point representing the local government perspective.

Amongst other services provided by local governments associations, coordinating local governments lobbying actions towards national governments and developing a partnership approach towards central state organs is crucial. National Associations of Local Government need to identify a 'champion' of decentralization within the Central Government and launch partnerships. Ensuring that amongst state institutions, one is especially defending local government's role in infrastructure financing is crucial for enhancing the dialogue and future debate between governments.

4. Develop their capacities and get involved in peer to peer practices.

Through their national associations but also directly, local governments can share and learn from each other in local finance. Successful initiatives taken at the local level can to some extent be adapted to another local government. Moreover, through regular contacts amongst local governments technicians in local finance, an active support network can be established for the benefit of all.

**DEALING WITH CONSTRAINTS
ON LOCAL GOVERNMENT
ACCESS TO CREDIT**

1. CURRENT SHORTCOMINGS ON THE SUPPLY SIDE: A NEED FOR AN IMPROVED INTERMEDIATION

1) Enabling Local Governments Access Long Term Debt: Current Constraints

Local Governments need to access long term debt to invest in local public infrastructure, i.e. obtain loan maturity from 10 to 20 years, close to the physical life of the infrastructure.

- Concerns expressed by Local Governments

However, local Governments often report numerous difficulties in approaching lenders to finance their public infrastructure. When they had the chance to have contacts with a potential lender, local governments generally put the following concerns forward:

- the lack of long lasting partnership for the implementation of their multiyear investment plans; financial institutions focusing often only on a single investment project;
 - the high interest rate proposed by the financial partner;
 - negotiations time for a loan, which can easily last about 3 years, especially with development banks (far too long given a Mayor's usual mandate);
 - the short tenure of the potential loans, as nascent credit markets provide up to 5-8 years term.
- Structural Inadequacies of The Markets Make Them Unable to Serve Local Governments

In fact, private markets and banks are not on-lending to small or medium municipalities (and some experts would say that it never happen in 200 years of local public borrowing history) for the following reasons:

Throughout Central Europe several efforts and projects to develop bank loan and municipal bond financing were promoted in the 1990s. In some countries, a transition to a thriving municipal credit market was effected relatively rapidly while in others it was not. What conditions enabled this evolution?

- Rapid transfer of formerly state-owned surplus public properties (i.e. potentially revenue-generating) to local governments, which could serve as an initial source of collateral for loans (Poland, Hungary, Czech Republic, Slovakia)
- Stable and autonomous sources of Local Government financing which enabled Local government to generate positive and high levels of net operating savings which could be used for investment and/or to leverage debt financing (Poland, Czech Republic)
- Local government accounts placed in commercial banks, allowing additional collateral via garnishment option of local bank account or intergovernmental transfers (Poland, Hungary, Czech Republic, Slovakia)
- Local borrowing frameworks which focused on more of a market-oriented a posteriori control and regulation, rather than a priori state approvals.

Box 9
Development of Credit Markets in the Transition Countries of Central Europe.

- Transaction costs are high due to the small size of the loan.
- There is a structural mismatch between commercial banks' resources, which are by definition mainly short term, like deposits, and the issuance of long term loans.

In developing countries, only capital cities tend to succeed in accessing the market and debt (Joburg, Hochiminh, Mexico), often thanks to specific relationships with the central state (which provides a sovereign guarantee). However, small and medium municipalities are too often deprived of access to debt.

Additionally, in order to have credit markets and banks offering such long term debt, specific requirements must be met in terms of security needs and collateral (to offer the banker the possibility to get paid in case of default), as well as intercept mechanism on Intergovernmental transfers or other source (which aim at securing the regular flow of repayment). These requirements imply a certain maturation of the credit markets, which rarely exists in developing countries and will only develop with time. This transition period can be long and the current urban expansion cannot wait for national credit markets to mature.

2) The Need for Intermediation at the National Level

- Intermediation Often Implied Public Intervention

Public intervention is often needed to promote local public infrastructure long term financing, whether through the funding of financial institutions or the development of fiscal incentives.

In developed countries, central governments funded or supported the establishment of fi-

ancial institutions specialized in lending towards local government, like the Caisse des depots et consignations (1816) in France, KommuneKredit in Denmark (1899), Norges Kommunalbank in Norway (1926), or the multiple Bond banks in the US (where federal state and member state shared the funding of these banks dedicated to lending for a specific infrastructure like water and sanitation to local governments), etc.

In developing countries, central states established Municipal Development Funds (MDFs) to provide grants and loans to local governments to finance their local public infrastructure. There are more than 70 institutions in developing countries. Many were set up with the support of multilateral development bank lending (guaranteed by the State) and limited their activities to channel these loans to local governments. Three main goals of MDFs can be listed:

- promote local financial and economic development via infrastructure;
- promote the use of borrowing mechanisms for capital improvements;
- develop local government financial and borrowing capacities. Nonetheless, the principal aim is to help small and medium size municipalities' access credit.

- Reviewing Financial Institutions Performance in Lending Operations Towards Local Governments

However useful, the MDF performance is often criticized. Interest rates provided are perceived as too high and non affordable. In some countries, the selection process of projects or local governments to be funded is not always justified and led to numerous defaults, which threatened the existence of the MDF itself. Several MDFs have been reported to keep a significant amount of available liquidities unused. The management structure of these institutions, too often solely accountable to the central state, is also questioned. Some-

times, the willingness to transform an MDF in a normal bank has left out numerous medium size local governments.

Nonetheless, lessons can be drawn from the failures and successes to review the existing non-performing MDFs and develop new and more efficient institutions. An agreed diagnostic and common strategy, involving local governments as key stakeholders, could help revitalize the concept of these financial institutions.

Conclusion: To enable local governments to effectively access long term

debt in the coming years (and not after the urbanization has happened), a pragmatic approach towards local government funding must be developed on the supply side at the national level. The role of municipal development funds must be considered and reviewed, with the close involvement of their main beneficiaries, the local governments. Local governments must be recognized in the role that they can play to support the necessary reform of the financial sector, in order to enhance their responsiveness towards local governments needs.

2. A CALL FOR IMMEDIATE ACTION: RECOMMENDATIONS TO OUR PARTNERS FOR JOINT SUCCESS

As for the demand side, these recommendations on the supply side would need to be evaluated and prioritized in the context of particular countries.

1) Towards National Government

Central governments are called to allow local government's effective access to borrowing by building an environment conducive to financing for local infrastructure from domestic savings and available liquidities, and in particular by reforming municipal development funds.

1. Enable local governments effective access to local public borrowing:

Legal frameworks should be adapted to allow local governments to borrow for their local public infrastructure.

2. Review specialized financial institutions:

Established by national governments to support local public infrastructure, municipal development funds have sometimes collapsed or survived with difficulty. Assessing their current performance, drafting their reform and involving the local governments as their first beneficiaries in their management are key steps forward.

3. Actively promote the development of domestic financial markets for local governments:

National government can take several initiatives that would help further development of local credit markets:

- Enable intercept mechanisms.
- Facilitate investment in municipal bonds or municipal credit of insurance companies, pension funds and other potential investors. The State could provide guarantee requirements and incentives to local public infrastructure investments such as tax reduction (for buying municipal bonds or shares)
- Support training to bankers to learn to analyze local government finances, to identify what is a creditworthy local government, etc.

2) Towards Bilateral and Multilateral Financial Institutions and Donors

Bilateral and Multilateral financial institutions and donors are called to:

1. Develop a coherent strategy to address the investment needs of small and medium-sized authorities.

The development community should swiftly change their approach from an urban strategy to a local government strategy, from a sectoral technical approach to a global approach based on the development of the local government as such. It is worth mentioning that to the best of our knowledge, a first bilateral development bank reorganized itself in 2007 in establishing a local self-government department (and not an urban department).



Moreover, development banks and donors should define clear, consistent and long term strategies for small and medium size local governments in order to address their investment needs. Reforming Municipal Development Funds should be also considered as a key item of this strategy.

2. Support supply side reform and especially Municipal Development Funds in raising their performance and in involving local government representatives.

Development Banks and donors often played a crucial role in setting up these institutions. They should keep on supporting the MDFs, however especially in raising their performance and in suggesting them to consider local governments as key stakeholders.

3. Increase the volume of loans directly channelled to local governments, with or without sovereign guarantee.

Amount of loans provided to local governments should be increased to tackle the urban challenge. Existing lending programmes should be reviewed accordingly.

4. Present mechanisms for extending the period of loans and for reducing the interest rates offered to local governments.

Multilateral and bilaterals agencies should initiate and support credit enhancement mechanisms which would lengthen the term of the debt and reduce its rate: blend of long-term subsidized interest rate multilateral loan with a short term local loan (in order to provide a national currency loan with lower rate to local government), through a local bank or MDF.

5. Ensure that local governments benefit significantly from public development aid. UCLG would propose that at least 20% of public develop-

ment aid is allocated to local governments and through decentralised co-operation.

Amongst the regular USD 60 bn dedicated to development programmes from the donor community, a tiny part concerns local governments, despite the fact that they are directly facing the urban challenge. UCLG will engage donors in channelling at least 20% of the total development aid (around USD 20 bn) to local governments and additionally in directing it through decentralised co-operation, which is often offering long term support and exchange between local governments.

6. Systematically include local governments in the design and implementation of aid instruments intended for local governments.

When designing and implementing aid instruments directed to local governments, donors should consult and include local governments and their associations. The municipal movement cannot be indeed strengthened if successive aid instruments towards local governments are not designed and managed without local governments associations' insight and commitment.

3) Towards Local Governments

Local governments are committed to:

1. Promote innovative mechanisms such as the "Bank of Cities".

If local governments failed to access finance and credit, the project of the World Bank of Cities, as well as other initiatives providing access to credit for small and medium municipalities, should be further developed in order to provide an alternative source of funding for local public infrastructure.



2. Be proactive in proposing new policies:

Local governments shall not wait for national governments nor development banks and

donors to engage the necessary reform of the supply side, but proactively suggest the steps forward to all partners. In particular, local governments must be more proactive in monitoring performance of MDFs.

Box 10
Improving Urban Infrastructure:
Other Recommendations put forward by Local Governments.

Complementary and alternative proposals to boost local public infrastructure financing: on the need to link urban and financial planning more closely, and on the possibility of reaching national agreements between partners (central government, local governments, lenders and donors) that would improve the implementation of these recommendations were also put forward by local governments.

1. Reform national and local public enterprises providing basic services at the local level. Central and local governments are called to:

- Review pricing policies to cover operational costs and channel subsidies towards the urban poor.
- Improve mutual information and coordination with local governments planning to enhance infrastructure coverage and funding.

In many countries, effective local public urban infrastructure is hindered by inefficient pricing; which in fine impede the poorest part of the population of accessing to basic services. Both at local and central level, aiming for cost recovery fees would enable more funding for new infrastructure. Taking into account the current high level of subsidies and the fact that it might and could not be reduced overnight, the idea here would be to channel these subsidies more effectively towards the urban poor.

2. Linking urban and financial planning. Local governments and their partners are called to:

- Elaborate realistic multi-annual investment plans with funding sources identified in relation to the master plan.
- Review fiscal tools to discourage urban sprawl and promote compact urban development.

Several local governments involved in lengthy and costly master plans but were just unable to implement it and had to face a swift urbanisation by taking ad hoc decisions, because the finance was not properly planned and thought for. When developing urban plans, local governments and their partners must elaborate realistic multi-annual investment plans with funding sources identified. Such an effort will facilitate long term partnerships with banks, donors, states as well as private partners.

Moreover, urban sprawl can be fought amongst others by appropriate fiscal tools. Local taxes could be reshaped with a view to discourage urban sprawl and promote compact urban development. Local governments which developed these tools could share their successful experiences and urban planners should consider developing such apparatus.

Furthermore, reforming the institutional setting within the metropolitan areas should be considered, as fighting urban sprawl needs a coordinated and integrated approach including all local territories depending from the metropolitan dynamic.

3. Developing national agreements between partners

To ensure a swift implementation of these recommendations, partners should commit nationally around the same overall objective, specific indicators being developed for each partner. For instance, national agreements could ensure that:



- Central governments would commit to review fiscal decentralisation frameworks and engage into a five year plan ensuring regular transfers to local governments,
- Local governments would commit to improve their taxes and fees collection by a given percentage over five years,
- Municipal Development Funds would enhance access to credit for small and medium municipalities, improve their performance and involve local governments in their management,
- Donors and Development Banks would support these reforms by offering grants and loans to the partners.

A set of pilot countries where such a national agreement could be established and implemented



CONCLUSION

Time is of the essence and massive finance must be channeled to local governments to effectively support the necessary equipment of the growing urban conurbations.

As shown by several past and recent experiences, local governments can efficiently face the urban challenge if immediate actions are taken on both demand and supply side.

On the demand side, local governments must be vested with sufficient and regular resources to access long term credit. Stability and adequacy of municipal finance must be guaranteed by improved fiscal decentralization frameworks.

On the supply side, enabling local governments' effective access to credit will often imply a re-think and reform of the financial sector and especially of the financial institutions specialized in lending to local governments.

Recommendations should be prioritized in each country and implemented in a strategic process. In order to ensure immediate action and the suggested recommendations to be followed up, UCLG advocates for the development in several countries of a national framework action plan.

Following the UCLG Policy Paper on Local Finance, and with a view to ensure implementation of the recommendations, UCLG will develop its activities to:

- Promote local government access to finance for local public infrastructure through:
 - Strengthening dialog with local government partners about their forthcoming actions; Lobbying Bilateral and Multilateral Financial Institutions and Donors about their strategies for small and medium local governments; Improving and simplifying current lending processes to local governments.
 - Actively participating to the Bank of Cities project and especially investigate pooling and funding mechanisms.
- Assist UCLG members lobbying for systemic change and local public finance reform by:
 - Improving access to valuable local finance information.
 - Contribute to the reform process of fiscal decentralization frameworks and Municipal Development Funds at the request of UCLG members.

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