

Financing the Infrastructure Cities Need

Steps towards developing sustainable infrastructure financing for cities

UN HABITAT
FOR A BETTER URBAN FUTURE

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The purpose of this paper is to discuss key drivers in developing an effective system of local government finance. Good local government finance enables cities to generate sustainable endogenous revenues for infrastructure and public service provision. The paper suggests a path towards creating national enabling frameworks, and how the international community can support urban finance reform.

Introduction - cities need robust and sustainable funding to develop the infrastructure they need

Rapid urbanization has been a driver of global growth and poverty reduction. Although cities are economic engines and should be national priorities, governments struggle to finance the infrastructure they need. Lack of infrastructure is threatening the competitiveness and productivity of cities and national economies.

Most cities in the developing world still rely heavily on transfers from national governments and grants to finance needed infrastructure. Despite efforts to reduce dependency on their central governments, local governments are less self-sufficient today than they were 15 years ago.¹ Municipal functions have become more complex, and local governments are under increasing pressure to do more with less. Cities need to implement new funding instruments that will yield more robust and sustainable revenues.

Towards a system of local government finance

Key players recognize the economic importance of cities and their need for sustainable resource flows; however, sufficient actions are rarely taken to enable cities to reach their potential. Effective financing mechanisms that exist within strong legal and institutional frameworks are needed for improved infrastructure, urban expansion and service provision.

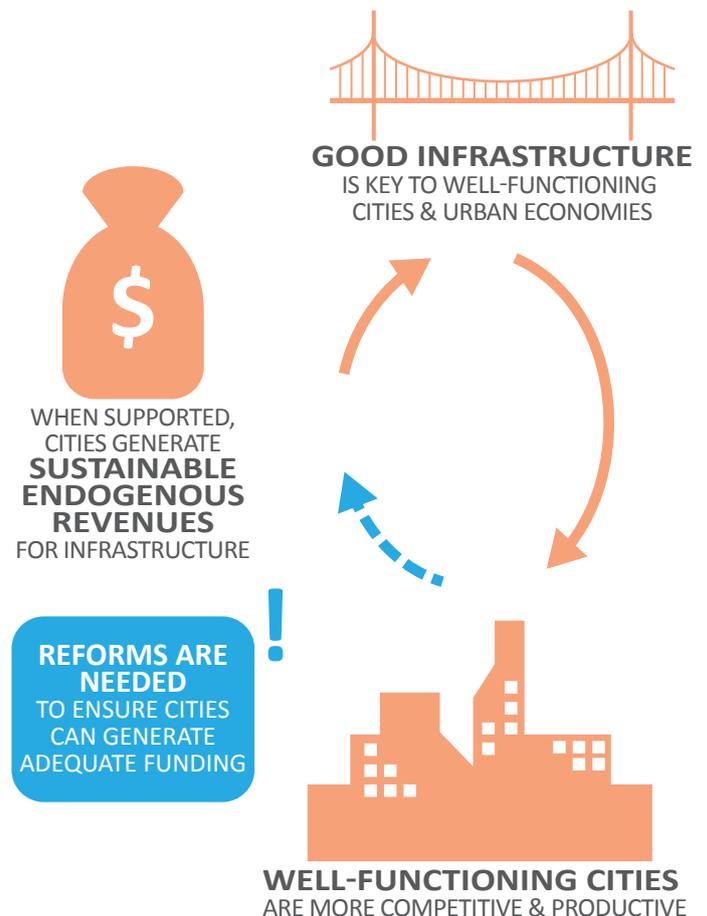
Support from the international community could be instrumental in helping to develop an effective system of local government finance. Generally, international support needs to focus on:

- establishing enabling frameworks for resource mobilization and capital market development;
- strengthening local capacity to mobilize resources; and
- access capital markets and funding.

Urban development is a well established sector, supported by governments and the international community. Urban finance is a new and growing subsector, involving organizations including United Nations Capital Development Fund, United Nations Human Settlements Programme (UN-Habitat) and the World Bank.

UN-Habitat coordinates with local governments to increase endogenous sources of revenue, for example through raising property taxes and land value capture. UN-Habitat also engages with local governments to improve credit worthiness.

MUNICIPAL FINANCING MATTERS



KEY POINTS²

- Many cities lack development resources, yet there is untapped potential in subnational taxes.
- Localization, the process whereby local governments have greater responsibility to provide infrastructure and services, is increasing.
- Local governments are learning to deliver services more effectively with better public financial management when given more responsibility and autonomy.³
- Restricted access to markets is an issue for local governments in developing countries. Just 4% of 500 cities in low income countries have access to international markets.⁴

The following sections discuss key drivers in developing an effective system of local government finance.

Improving governance systems

Governance systems provide the political and organizational context for the process of revenue mobilization, and determine the potential mobilized revenues. There are three key shortfalls in global urban governance.

1. Local governments often lack jurisdiction over the totality of an urban area, and coordination between institutions does not effectively cover sectoral silos. As a result, local governments may be too small to form a coherent, long-term, inclusive economic vision or sufficiently leverage needed resources.
2. Often inadequate structures exist for integrated urban planning and intergovernmental fiscal relations. Inadequate structures and poorly enforced development controls lead to adverse environmental and social outcomes, and an uncertain regulatory environment for investors that results in increased infrastructure and other urban development costs.
3. Inadequate support exists for building an effective and financially viable process of urban development. Many countries have training programmes to strengthen local government performance; however, programmes often fail to address broad structural issues.

Bridging shortfalls in endogenous resources

Cities' abilities to raise revenue from sources under their control is crucial for their longer-term sustainable development. Several related issues include the following:

- Cities may not levy and collect all the taxes and user charges they are supposed to and entitled to levy and collect.
- The design of local tax systems may be outdated and no longer reflect current circumstances, capabilities or best practices.
- There may be need for the addition or extension of taxes to meet specific development objectives.

Building better local financial and asset management systems

Funding local projects from local sources is generally regarded as beneficial, and efficient use of public funds is a key concern. Towards these aims, local governments must be well managed. The following are guiding principles for reform activities:

- Once revenues are mobilized, funding must be used as efficiently as possible.

PROPERTY TAX HAS UNTAPPED POTENTIAL IN DEVELOPING CITIES PROPERTY TAX REPRESENTS...



Source: Author with World Bank data⁵

JAWAHARLAL NEHRU NATIONAL URBAN RENEWAL MISSION

JNNURM was launched in December 2005 by India's central government to provide local governments funding for urban infrastructure and governance, and basic services to the urban poor.

To be eligible, local governments must undertake certain mandatory reforms (see below). Additionally, local governments are required to implement five optional reforms, such as bylaws to streamline the approval process for construction, introduce a property title certification system, and introduce computerized land and property registration and administration.

- Urban local bodies must recover full operations and maintenance costs over 5 years, and adopt accrual accounting, e-governance and pro-poor budgeting.
- State governments must repeal the Urban Land Ceiling and Regulation Act, reform rent control laws and establish independent regulators for urban services.

FINDETER

The Government of Colombia instituted FINDETER in the late 1980s. The economic development policy works through second-tier public financial institutions that specialize in priority sectors. It employs a discounting mechanism to lend to public service providers through financial institutions.

Changes to the policy in 2003: expanded its automatic discounting system; made its products more flexible; diversified its portfolio to encompass new sectors, clients and private sector sub-borrowers; scaled back technical assistance to public service providers; and took steps to improve its integrated risk management. Since 2002, FINDETER's profitability has improved steadily and its credit exposure has been reduced. FINDETER now secures most of its funding on the local market through issuance of certificates of deposit. Local funding sources are blended with other sources from abroad with longer terms that minimize the maturity mismatch of its loan portfolio.

¹Gadonne, L.; Singhal, M. 2014. *Decentralization in Developing Economies*, in Annual Review of Economics, Vol. 6, pp. 581-604.

²Key Points are adapted from: United Nations Task Team on Habitat III. 2015. *Issue Paper on Municipal Finance*. United Nations, Habitat III Issue Paper No. 7.

³A World Bank study of 190 projects involving 3,000 municipal development projects concluded that increased autonomy and responsibility resulted in better access to services and increased scope of services: World Bank. 2009. *Improving Municipal Management for Cities to Succeed*.

⁴World Bank. 2013. *Planning and Financing Low-Carbon, Livable Cities*.

⁵C. Farvacque-Vitkovic and M. Kopanvi (eds.): *Municipal Finances: A Handbook for Local Governments* (World Bank, 2014).

- Subnational governments should improve transparency by providing easily accessible public data on the provision of infrastructure and services, and link their expenditures to tax and fee collection.
- Budgeting should occur in context of an integrated city-wide financial and asset management plan. Decisions regarding expenditures and procurement should be based on the most effective means of providing the planned and mandated services to the city. The most effective means of service provision may be public, private or joint. Even given an investment plan, few examples of structured systems capable of leveraging public funds with community and/or private sector funds exist.
- Although controversial, systems may benefit from the sale of certain government assets in order to procure new assets and provide services.

Developing systems for effective use of exogenous sources of finance

Local governments should first focus on maximizing the potential of their endogenous resources, and strengthening and improving their financial capabilities. Then, local governments can maximize their leverage of endogenous resources and tap wider sources of finance. National policy needs to address issues of city financing and recognize the need for national systems to prudently evolve.

Establishing better systems for infrastructure finance

Prioritizing and financing infrastructure investments need to take place in the context of a rational plan for urban development. Typically beyond the capacity or jurisdiction of one local government, success of infrastructure projects and funding depend on cooperation of all concerned governments. Implementing authorities should include stakeholders from all concerned governments and financing instruments that cater to each government's various circumstances.

Linking key drivers to needed actions

The key drivers described above each have implications for transitioning from current practice. As discussed, creation of a national enabling environment is crucial for changes to take place. The table on the following page links key drivers in developing an effective system of local government finance with the necessary conditions to move forward and create an enabling national framework.

TOWARDS AN EFFECTIVE SYSTEM OF LOCAL GOVERNMENT FINANCE

1 INITIATE REFORMS IN SUPPORT OF ENABLING FRAMEWORKS

NECESSARY REFORMS TO ENSURE CITIES CAN GENERATE ADEQUATE FUNDING



2 INITIATE ENDOGENOUS FUNDING MECHANISMS SUCH AS LAND VALUE CAPTURE, PROPERTY AND OTHER SUBNATIONAL TAX REFORMS



CITIES GENERATE SUSTAINABLE ENDOGENOUS REVENUES



3 BENEFIT FROM BETTER CREDIT RATINGS, AND ACCESS TO BONDS AND LOANS FROM LOCAL AND INTERNATIONAL MARKETS



CITIES USE EXOGENOUS REVENUES EFFECTIVELY

Different infrastructure financing solutions are needed depending on the sophistication of the capital markets and borrowers.

- **Land based financing** involves collaborative work by central and subnational governments to enhance potential sources of finance through mechanisms like municipal development banks or corporations. It requires appropriate institutional arrangements to be effective.
- **Building technical capacity to plan, access and administer a range of financial instruments** involves building the capacities of local governments to more effectively manage local revenues and expenses, and identify tailored financing options for needed infrastructure. Although capacity building can make a big difference and produce rapid results, more structured training is more effective for smaller local governments.
- **Diversifying financing** involves tapping capital markets and involving the private sector through mechanisms such as bond issuance, credit from commercial banks and public private partnerships. These instruments may be more appropriate for larger cities.

ACTION AGENDA FOR CREATING A NATIONAL ENABLING FRAMEWORK

| DRIVERS | CREATING A NATIONAL ENABLING FRAMEWORK | MAKING THE TRANSITION |
|--|--|---|
| IMPROVING GOVERNANCE SYSTEMS | Enact legislation for more effective financing instruments and increase capacity to utilize those instruments | National policy should encourage the formation of metro districts or legally-binding voluntary coalitions to link concerned governments and build financially-viable entities to implement infrastructure projects and urban services. |
| BRIDGING SHORTFALLS IN ENDOGENOUS RESOURCES | Follow best practices to structure efficient endogenous resource mobilization and support restructuring with effective programmes to build local government capacities | Clear mandates are needed for service providers to recover capital, and operation and maintenance expenditures from user fees and charges. Mandates should designate rational geographic coverage to enable economies of scale and the inclusive provision of services. All subsidies should be transparent and accounted. |
| BUILDING BETTER LOCAL FINANCIAL AND ASSET MANAGEMENT SYSTEMS | Provide incentives for the effective use of mobilized resources, shared taxes, transfers and asset management, and programmes to build capacity of and offer technical support to local governments | The structure of transfers should provide incentive for innovation. Assessment of assets should determine how services can be provided most effectively - through their sale or retainment. Retained assets should be assessed in terms of optimizing their utilization. New assets should be built after rigorous assessment of the investment case. |
| DEVELOPING SYSTEMS FOR EFFECTIVE USE OF EXOGENOUS SOURCES OF FINANCE | Implement programmes to: stimulate local government partnerships and increase capacities to manage partnerships; address issues related to local government borrowing and lending to local government; address barriers to accessing capital markets | Well-managed local governments should be enabled to borrow and enter capital markets to fund capital expenditures. Shift paradigms that characterize local governments as unreliable borrowers, encourage them to develop sound finance systems and become responsible debt managers. Concerted efforts are needed to eliminate market distortions and reduce transaction costs, enabling improved access to capital markets. |
| ESTABLISHING BETTER SYSTEMS FOR INFRASTRUCTURE FINANCE | Build institutions to address financing infrastructure issues; acknowledge infrastructure as a long-life asset, requiring multi-stakeholder collaboration, for which government ownership is not necessary | Financing project development, land acquisition, resettlement and other issues need to be addressed, and an integrated system of finance that is accessible to local governments needs to be developed. Where capital markets are still developing, special funding arrangements may be needed. |

What is needed?

To strengthen global urban financing processes there is a pressing need for:

1. **Clear acknowledgment** of and systems to support the economic primacy of cities at the national level, as well as commitment to appropriately finance urban development toward achievement of a sustainable urban economy.
2. **Coordinated action** to: 1) build effective institutions for service delivery; 2) support institutions' capacities for planning and finance; and 3) maximize integration and efficiency of such planning and finance.
3. **Support from the international community** to build a global city network fostering best practice in the above areas so as to maximize the contribution of urban economies for sustainable national and global growth.

More to Read

1. UN-Habitat: *Sustainable Finance for Development: Policies to Support the New Urban Agenda* (Nairobi, UN-Habitat, forthcoming).
2. UN-Habitat: *Finance for City Leaders: Municipal Finance for City Expansion* (Nairobi, UN-Habitat, forthcoming).
3. C. Farvacque-Vitkovic and M. Kopanvi (eds.): *Municipal Finances: A Handbook for Local Governments* (World Bank, 2014).
4. J.R. Bartle, W.B. Hildreth and J. Marlowe (eds.): *Management Policies in Local Government Finance* (Washington, DC, International City/County Management Association, 2012).
5. R. Bahl, J.F. Linn and D.L. Wetzel (eds.): *Financing Metropolitan Governments in Developing Countries* (Cambridge, Massachusetts, Lincoln Institute of Land Policy, 2013)