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ISSUE PAPER ON MUNICIPAL FINANCE

KEY WORDS

Revenue enhancement, financial management, transfers, decentralization, taxes, cadastral system, land value sharing, basic infrastructure, services, local assets, transparency, accountability

FIGURES AND KEY FACTS

- Globalization continues at a fast pace, but localization, the process whereby local governments have greater responsibility to provide infrastructure and services, is also increasing. While globalization has been rapid, urbanization has been growing even faster and today there are more than 4,000 cities with populations over 150,000, and some 500 have over one million inhabitants.[1] Globally, cities generate over 80 per cent of the GDP, with similar shares in developing economies.[2]
- Despite their economic importance, cities are starved of development resources. In many countries local taxes and other revenue sources could be a major source of development finance but territorial governments are not allowed to expand their revenue base. In Developing countries, local taxes account for 2.3% of GDP, compared to 6.4% in industrialised countries.[3]
- Local governments are under pressure to do more with less. In many cases, municipal functions are becoming increasingly complex, encompassing issues of employment generation, social inclusion, and climate change. So, they have to be creative about finding sources of revenues and judicious in rationalizing their expenditures. Most cities in the developing world still rely heavily on transfers and grants and a great deal of effort is being made to reduce this dependency on central government. The structure of local revenues show that property tax is potentially a good source of local revenues but in most developing cities, property tax represents less than 3-4% of local revenues, compared to 40-50% in cities in Australia, Canada, France, UK and the US.[4]
- Local governments are learning to deliver services more effectively with better public financial management when they are given more responsibility and autonomy. A World Bank study covering 190 projects involving 3,000 municipal development projects concluded that increased autonomy and responsibility resulted in better access to services, for example water and clinics, and increases in the scope of services.[5]

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[1] UNDESA (2011) Population *Distribution, Urbanization, Internal Migration and Development.* *http://www.un.org/esa/population/publications/PopDistribUrbanization/PopulationDistributionUrbanization.pdf*
[2] World Bank (2015) *Urban Development Overview*
[3] Bird, Richard & Roy Bahl (2008) *Subnational Taxes in Developing Countries: The Way Forward*. Institute for International Business, Working Paper Series IIB Paper No. 16.
[4] Farvaque-Vitkovic, Catherine & Mihaly Kopanyi, Editors (2014) *Municipal Finances: A Handbook for Local Governments*. World Bank.
[5] World Bank (2009) *Improving Municipal Management for Cities to Succeed.* http://siteresources.worldbank.org/EXTMMNGT/Resources/Municipal_eval.pdf

- There are important opportunities for local governments to leverage their own resources with the support of national government and the international community. Local governments in developing countries rarely use alternative sources of funding such as those available from private sector, including in the form of loans from commercial banks or public private partnerships. Just 4% of 500 cities in low-income countries have access to international markets.[6] However international loans can expose local governments to exchange rate risk to which they have no natural hedge and which can be crippling. A number of countries prohibit this practice by law. Many local governments are a long way from credit worthiness and need to go through the unglamorous steps of keeping their books in order before entering the world of lending. There is such a thing as a bad loan and there is such a thing as a bad project.

ISSUE SUMMARY

Drivers of Global Municipal Finance

Many central and local governments recognize the importance of cities to their national economies. They also recognize that cities need a sustainable flow of resources and the necessary conditions to unlock endogenous financial resources to achieve sustainable urbanization. However they are yet act on that recognition. Effective financing mechanisms operating within a strong legal and institutional framework are needed to cater for urban expansion and to provide better services in existing urban areas. However, many city financing systems are structured for their role in the economy of a bygone era, rather than in line with global best practice.

Some governments, however, are more clearly defining the responsibilities of authorities for the delivery of urban infrastructure and services and better structuring transfers and mandates for local revenue generation to encourage efficiency in service provision, and in the management of resources for operations and capital investment. Yet this process needs to be extended and systematized. The sections below set out the key drivers in the development of an effective system of local government finance.

Improving outdated governance systems

Governance systems not only provide the political and organizational context for the process of resource mobilization, but, more importantly, the outcomes of urban governance systems determine the potential revenue mobilized. There are three key shortfalls in global urban governance:

1. Incoherence of urban institutions: urban institutions, such as local governments, very often do not cover the totality of the urban area, and planning coordination institutions do not effectively encompass sectoral silos – they are geographically and sectorally incoherent. In effect, this means that local governments are often too small to have a coherent long term vision (particularly a long term economic vision), to have sufficient financial leverage to achieve their visions, and to avoid political pressure from unrepresentative pressure groups resisting development with long term and geographically widely-spread benefits.

   A good example of the creation of geographically coherent structures come from Germany, where a regional authority has been created for Greater Stuttgart to coordinate regional economic development initiatives and transport. In terms of achieving sectoral integration, some developing countries have

[6] World Bank (2013) *Planning and Financing Low-Carbon, Livable Cities*.

raised their major cities to provincial level as in BMA (Bangkok Metropolitan Administration) for Bangkok and DKI Jakarta, although these structures do not encompass the full urban areas of these megacities. Perhaps, the best example in the developing world comes from South Africa, which has created well-empowered, territorially integrated “category A” municipalities for their large metro areas. This has resolved many of the vertical and horizontal coordination problems of the previous system. By and large, international experience indicates that it is very difficult to introduce effective vertical and horizontal coordination mechanisms between different local governments within the same large city area in low capacity environments. Institutional coordination tends to be the more effective path, wherever possible.

2. Inadequate structures for integrated urban planning and inter-governmental fiscal relations. While not immediately obvious, planning is strongly linked to financing as very significant real or potential revenue from taxes and fees comes from urban development, and the scale and efficiency of this development is, in turn, largely controlled by the planning process. Aside from the level of transfers, which is always considered by local governments as too low, the structure of many transfer systems provides perverse incentives for a variety of behaviours that reduce the efficiency of local governments. Basing transfers only on population, for example, provides no incentive for improved performance. In many developing countries, the relationship between planning and development does not hold due to lack of enforcement of development controls. Aside from leading to adverse environmental and social outcomes, the increased risk for investors from an uncertain regulatory context is passed on as increases in expected returns and in financing cost, in turn increasing the cost of infrastructure and other urban development.

   Nevertheless, good examples of planning, development, value capture and financing exist. The Hong Kong Metro, one of the few transit systems that actually cover capital and operating costs, is perhaps one of the most effective examples. Incentives for effective use of grants (and assets) also exist. The Philippines Department of the Interior and Local Government has a “Challenge Fund” to provide an incentive to local governments to invest in environmental infrastructure; and in Bangladesh, the Urban Governance Improvement Project rewards good performance by local governments with access to additional resources.

3. Inadequate support to building an effective and financially viable process of urban development. Insufficient support to the evolution of the institutional base and the strengthening of its capacities. Many countries have local government academies which aim to strengthen the financial performance of local government. However, the programmes offered tend to be very focused on building individual skills, which are essential, but not sufficient. Nonetheless, examples of more structural approaches to building broad based capacity exist. For example, in Indonesia the Capacity Building for Urban Infrastructure Management Project was formulated to support national and local institutions implementing the Integrated Urban Infrastructure Development Programme. Under the Programme, each participating city had to produce a Revenue Improvement Action Plan to demonstrate the capacity available to maintain the infrastructure being built under the Programme. The World Bank has also a large portfolio of lending projects focusing on Municipal Contracts, which provide an opportunity for local governments to work both on the strengthening of their daily functions (including financial management and revenue mobilization) and on investments. Benin, Cote d’Ivoire, Guinea, Madagascar, Mali, Mauritania, Rwanda, Senegal and others have been engaged in this process for many years.

Bridging shortfalls in endogenous resources

While national transfers discussed above are important, critical to the sustainability of developing cities in the medium to long term will be their ability to raise financial resources from their own assets. There are several issues related to this major driver:

- The first is whether or not cities are levying all the taxes and user charges they are entitled to levy (and which are net revenue earners – there is no point in collecting a tax which costs more to collect than it raises); whether they are actually collecting the taxes and user charges they, in theory, levy; and if they are levying them at the correct (maximum or cost recovery) level. The key question is: are there incentives in place to ensure that local governments actually collect all the taxes they are supposed to collect? In theory, central funds were linked to a reform agenda but, in practice, not much reform (especially in own source revenue collection) has been realized. There is a need to discuss the "infrastructure" needed to properly manage local taxation.[7] In particular when it comes to land based taxation such as land registration, there is a need to look at the functioning of judicial systems. In many developing cities, which are growing fast and informally, where property rights are difficult to ascertain, where registration systems are not working properly, property valuation and fiscal cadasters may not be the most cost-effective options.
- The second issue is the design of local tax systems as determined by national, state or provincial governments. Again, these designs were a response to circumstances applicable in years gone by and no longer reflect current circumstances, capabilities or best practice. For example, are property taxes based on highest best use of land and not on the value of the property on the land?
- The third issue is the need to increase the resources of local governments, in the context of insufficient resources for urban development – even given well-designed, well-implemented resource mobilization systems – through additional taxes or the extension of existing ones. For example, such measures may take the form of amortizing of a certain amount of, or creating surcharges on, national and local sales, income and corporate taxes, or the levying of property tax surcharges for specific purposes, for example Tax Increment Financing in the USA or betterment levies in Colombia.[8] Good examples of tax surcharges for local government are found in the US where local governments can, for example, levy a surcharge on income taxes. Hong Kong has excellent systems of capturing land value increase to finance infrastructure investments and the US PACE system of paying for environmental improvements is an excellent example of investment financed by property tax surcharges.

Again, it is important that national governments give due attention to the process of such issues, of moving to implement them, and of building capacity in the area of resource mobilization. This process will involve coordination across a number of national and local ministries or departments. The focal point for coordination needs to be given a clear mandate to undertake the process.

[7] The property valuation exercise may not be the most effective, since will run the risk of (1) cover a small part of the city; (2) have to be updated very quickly; (3) run its course after the international consultant leaves; (4) does not yield the expected revenue increase in the expected timeframe, so a better alternative is to explore the possibility of working directly with the municipality on street addressing which is much better suited for this type of environment and can be directly connected to many municipal applications. In municipalities where street addressing has been implemented, a 25 to 30% increase in local revenues has been achieved across the board, just by reconciling the street index with the fiscal registers.

[8] World Bank (2013) *Planning, Connecting and Financing Cities - Now.*

Building better local financial and asset management systems

Both from a theoretical viewpoint (OECD), and from some available evidence (US national transfers), funding local projects from local sources is seen as efficient. However, implementation is a persistent challenge. Once revenue is mobilized, it is essential that the proceeds be used as efficiently as possible.

Subnational governments should improve transparency, providing easily accessible public data on provision of infrastructure and services, and link those expenditures to increased taxes/fees collection. Efficient use of public funds is a key concern. It is essential that local governments be able to report their financial situation in a transparent and accountable manner to: a) their Ministries of Finance; b) their citizens; and c) their financial partners. The World Bank has been working on a Municipal Finance Self-Assessment tool (MFSA) to determine priority actions to improve transparency and effectiveness in the use of public funds.

Budgeting should be as a means to implement an agreed plan. Prioritization of expenditure – whether capital or recurrent – should be done on the basis of establishing the most cost effective way of providing the planned and mandated services to the city. Few cities have the capacity to prepare an investment plan, with plans balancing investment, operation and maintenance expenditure posing greater challenges. There are both regional support facilities (for example, the Cities Development Initiative for Asia) and national systems to develop prioritized investment plans, but they are not automatically integrated with citywide financial and asset management. Once investments are decided and funded, the city agency responsible has the duty of ensuring value for money when it procures the investment. Procurement systems are thus critical components of city financial systems. They must be both flexible and rigorous in respect of probity – a difficult mix requiring considerable skills.

There are some examples of structured systems capable of leveraging local and transfer revenues with community or private sector resources. The city of Chicago has the Chicago Infrastructure Trust, which has been effective in leveraging the city's resources for a number of projects including retrofitting to improve the energy efficiency of government buildings.

Effective use of the city's assets is a significant component of a good financial and asset management system. The question is: does the government needs to own assets to retain or recycle? Sale of government assets is controversial, but effective programmes that link sales to new assets and services, such as the government of New South Wales' Asset Recycling Programme in Australia exist. Ministries of Finance tend to dislike such hypothecation of revenue, but citizens can see direct benefits from them and are may support them. More flexible use of government assets is also possible, but agencies tend to fiercely defend their stocks. Again, such decisions are best made by a cross-jurisdictional, cross-sectoral agency.

Many cities are required by law to prepare and implement a Capital Investment Plan. However, many lack capacity to do so. The World Bank has, in parallel to the Municipal Finance Self-Assessment, developed the Urban Audit, which helps local governments to: 1) assess their needs in terms of services and infrastructure; and 2) prioritize their investments programmes in a way, which is consistent with their financial capacity. This tool does not pretend to substitute or replace the mandatory local planning and programming documents but, rather, provide a jumpstart to the investment prioritization process and a platform for greater coordination among the various municipal departments in charge of finances, city planning, public infrastructure and public utilities.

Better systems for infrastructure finance

Infrastructure is a special case as it is a "lumpy" asset, meaning it has a high construction cost relative to recurrent income of most jurisdictions, it is often cross-jurisdictional, meaning its provision needs to be coordinated over two or more political jurisdictions if it is to be financially viable and it is a long lived asset giving rise to inter-generational issues in funding. It is also an asset prone to mismanagement in terms of under-funding or inflating of operation and maintenance or capital costs.

Prioritizing infrastructure investments and the financing of those investments thus needs to take place in the context of a rational plan for city development. However, the financing of trunk infrastructure in a large urban area is typically beyond the capacity of one local government. Paradoxically, even if a project is implemented by a cross-jurisdictional, cross-sectoral entity,[9] the success of the project and of the financing often needs the cooperation of all concerned local governments. Cross jurisdictional, cross sectoral implementation has proved to be difficult in low capacity environments.

Transit Oriented Development projects, such as the one in Atlanta, USA, often provide good examples of cross-sectoral development along corridors. Such projects constitute good interventions on the demand side of infrastructure provision, providing the long term planning and revenue base on which to build a viable financing package. On the infrastructure finance supply side, there are different solutions depending on the sophistication of the capital markets and of the borrowers – from project bond based financing subscribed to by institutions (mainly pension funds) in Canada, to the Tamil Nadu Urban Development Fund's pooled financing mechanisms used for financing infrastructure in small local governments in India.

Implementing such mechanisms needs innovations in governance, fiscal incentives, and incentives for improved financial and asset management; supported by reforms in the capital markets and by international development assistance agencies and private sector. There is also a need for a dedicated agency for this, which can be the Ministry of Finance. Among the mechanisms in particular:

- Land based financing is becoming a major potential source of funding for infrastructure and other services, but it needs appropriate institutional arrangements to be effective. Central and territorial governments need to work together on enhancing the potential sources of finance through such mechanisms as municipal development banks or municipal development corporations as appropriate to the financing needs of cities for their infrastructure.
- The technical capacity for planning, accessing and administering the range of financing instruments is a major challenge for smaller municipalities. Capacity building programmes, that provide the basis of effective financial management, can make a big difference and produce rapid results. For smaller local governments, more structured programmes encouraging the more efficient management of local revenues and expenses, and supplying tailored finance for infrastructure, may be more effective.
- For larger cities there is a need to diversify sources of finance, encouraging them to tap the capital markets and to involve the private sector through mechanisms as bond issuance (requiring credit ratings), credit from commercial banks and Public Private Partnerships.

[9] For example, water and sewerage infrastructure needs to be augmented if densities are being increased in a Transit Oriented Development project.

Developing Systems for Effective Use of Exogenous Sources of Finance

Improving municipal finance is an incremental process and the mechanisms used evolve over time as the circumstances of the city and the national capital markets change. Critically, local governments should focus first on getting the basic conditions right, by maximising the potential of their endogenous resources and strengthening and improving their financial capabilities. When the "house is in order" local government can, in turn, maximise their leverage of endogenous resources and tap wider sources of finance as available in the country concerned. For example, where the national policy context provides for it and where capital markets are capable of providing long-term sub-sovereign debt, cities should aim to attain credit ratings needed to access bond markets and potentially in international markets. Where such conditions do not apply,[10] a sound financial base will enable them to access more conventional forms of finance such as municipal development funds and pooled financing mechanisms, on the best possible terms. Local governments have been able to successfully issue bonds, though results are mixed. Outside of South Africa, no cities in Africa are issuing bonds. The recent case of Dakar (whose bond issuance has been suspended by the Minister of Finance) shows that cities are not there yet in many parts of the world. In India, barring a few cases such as Ahmedabad, there is no track record.

National policy needs to squarely address the issue of city financing and the need for national systems to evolve. But national institutions must ensure fundamental prudential mechanisms – such as rigorous assessment of debt service capacity – are maintained as the system evolves.

- There is much to be said about the links between serious commitment to decentralization and city finances. In many developing countries, the political commitment to decentralization remains weak if such efforts exist – especially in the case of municipal development funds. The case of Findeter (Financiera de Desarrollo Territorial) in Colombia is instructive as it moved from its roots as a municipal fund to become a sophisticated bank for sub-sovereign infrastructure finance. In developed countries, municipal finance systems have developed mechanisms such as bond banks (Finland, Spain, Sweden and cities in the United States) which act as intermediaries offering guarantees and pooling resources from local and international investors.
- National governments have also encouraged cities to improve their credit rating as a pathway to improved municipal finances and expanded resources,[11] and some cities are aiming for investment grade ratings that can even allow them to access international markets. Mexico is a good example in using city credit ratings as part of its local financing systems for infrastructure.

KEY DRIVERS FOR ACTION

The Way Forward

There needs to be a coherent and internationally supported national process of developing financially sustainable urban systems. These processes need to target the key drivers of urban development discussed above. In the context of well thought out economic development plans, actions need to focus on the areas set out below:

[10] Conditions among countries differ greatly and different approaches are required to strengthening the enabling framework for financing local governments from the capital market. See, for example, Sood, Mays and Lindfield (2012) *Subnational Finance for Infrastructure* ADB Sustainable Development Working Paper 20.

[11] The World Bank has introduced a Creditworthiness activity which includes some face to face workshops (Academy).

- Governance reform: a national process to clarify responsibilities for, and build institutions to deliver and finance urban infrastructure and other services across different levels of government in an efficient, transparent and accountable manner.
- Expanding endogenous resources: national and local reform processes to provide opportunities and incentives for increasing the local resource base and efficiency in the use of these resources and of government assets, including enabling local government to access the capital markets and to leverage its funds with private sector resources.
- Strengthen financial and asset management: strengthening national and local institutions to encourage more effective management by territorial governments of local revenues and expenditures, and of their assets.
- Improving urban infrastructure finance systems: a nationally-facilitated process to expand sources of, and instruments for, financing for capital investments and the recovery of costs from the beneficiaries of such investments.
- Developing systems for effective use of exogenous sources of finance: national governments providing the opportunities and incentives for effective use of exogenous resources on the one hand and the conditions for the prudent supply of such resources on the other.

SUMMARY

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

1. Clear acknowledgement of, and systems to support, the economic primacy of cities at the national level and commitment to appropriately finance urban development so as to achieve sustainable development of the urban economy.
2. Coordinated action to: build effective institutions for service delivery; support institutional capacity for planning and finance; and to maximize the integration and efficiency of planning and finance; as well as actions to provide incentives for best use of both own-source revenue and transfers, and leveraging of private sector in funding and efficient use of assets.
3. Support from the international community to build a global city network fostering best practice in the above areas so as to maximise the contribution of urban economies to sustainable national and global growth.

PLATFORMS

- World Bank: Municipal Finances: A Learning Program for Local Governments.
- UN-HABITAT: Through the Achieving Sustainable Urban Development (ASUD) initiative follows a three legged approach to sustainable urban development, integrating planning; legislation and finance for planned city extensions and infills. Within the context of finance, the organization focuses on endogenous sources of finance such as property taxes, land value capture, public assess, and other sources of finance, and coordinates with local governments.
- UNCDF: United Nations Capital Development Fund. Works in least developed countries promoting inclusive finance for citizens and local development finance.

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