



# Local financing and access to external resources: what are the options and conditions for implementation?

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To cope with "enormous financing needs"<sup>1</sup>, local governments must mobilize *all* available resources. In developed countries, public investment depends largely on local governments: On average, they are responsible of 70% of public investment within the OECD countries. Regarding emerging and developing countries, the challenges associated with population growth and urbanization put local governments, now and for the future, at the heart of responses to a growing demand in infrastructure.

In this context, we will look at the mobilization of external resources by local governments and the conditions of this mobilization in particular. This study is centered around private sector involvement, which can be more widely called the financing mechanisms responding to a market logic. These appear to be essential to mobilize the resources necessary to developing countries in order to catch up with years of under-investment, even when world savings is considerable enough to respond to development challenges<sup>2</sup>.

Therefore, our work must contribute to answering the following questions: How do we meet the lifelong supply and demand for funding while local-level investment needs are growing? Are calls for external financing reserved only for communities with good creditworthiness? What financing tools allow the greatest number of communities to finance themselves?

One of the main motivating force is to go beyond the simple technical aspects that make a mode of financing work in a given country, at a given time and in a given context; it is also about taking into account the institutional, legal, socio-economic, and even political aspects for each local context where various modes of financing have been implemented. This dual approach should allow us to better understand the conditions which allow the incremental passage of a one-way system, where transfers from the central government to local governments and/or grants and subsidized loans from bilateral and multilateral donors were the rule, to a situation that bring the interests of financial and political actors into line with each others, enabling a strategic use of transfers, grants, other concessional loans and partnerships with the private sector to leverage and mobilize private national savings.

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<sup>1</sup> On December 2014, the secretary-general of the United Nations urged "not to forget that it is at the sub-national level that many investments will be made in favor of sustainable development and that it is local authorities who will take the initiative". Thereby local governments are facing "enormous financing needs" (United Nations, 2014, p. 25).

<sup>2</sup> The "Report of the Intergovernmental Committee of experts on financing for sustainable development" of the United Nations estimated that "world savings is robust, at around 22 000 billion dollars per year" (if we add private and public savings) (United Nations, 2015, p. 9)

The preferred methodology comes from a literary review of case studies carried out on the mobilization of external resources by local governments around the world. It is on the basis of these case studies that the conditions for the mobilization of external resources will be discussed. After having briefly presented our sources and methodological approach (chapter 1), we will focus on the catchment area of the "request for funding", to discuss the key elements that enable local communities to "transform" investment needs in funding applications and meeting an offer (chapter 2). Chapter 3 then focuses on the mobilization tools for external resources and their conditions of success (or failure). Finally, chapter 4 includes concluding remarks, which will serve as pillars for the field analysis to be carried out in the second phase of this study.

## I. Elements of the methodology

We have worked on 34 case studies, covering 4 continents - Africa, America, Asia and Europe - and 25 countries (South Africa, Germany, Colombia, Croatia, United States, India, Pakistan, the Philippines, Senegal, Sweden, Turkey, etc.), for various levels of government (city of Johannesburg, Moroccan communities as a whole, Lagos State in Nigeria, communities of the State of Tamil Nadu in India and even the Serb commons and the municipality of Istanbul).

They are derived from 5 main sources: the book of T. Paulais, *Financer les villes d'Afrique*<sup>3</sup>, the book edited by A. Munawar, *Municipal infrastructure financing: innovative practices from developing countries*<sup>4</sup>, the working document from the World Bank by R. Kehew, T. Matsukawa and J. Pertersen<sup>5</sup>, *Guidelines on local government borrowing and recent development in NALAS countries*<sup>6</sup> and the note by E. Cox and K. Schmuecker<sup>7</sup>, "Beyond banks and big government: strategies for local authorities to promote investment". Elements drawn from these 5 main sources have been complemented by many other sources, consisting of publications of international organizations such as the OECD and the World Bank, research institutes and foundations, such as The Urban Institute, and to a lesser

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<sup>3</sup> Paulais T. (2012), *Financer les villes d'Afrique : l'enjeu de l'investissement local*, Pearson Education France, 417 pages

<sup>4</sup> Munawar A. ed. (2010), *Municipal Infrastructure Financing: Innovative Practices from Developing Countries*, Commonwealth Secretariat Local Government Reform Series, Commonwealth Secretariat, 142 pages

<sup>5</sup> Kehew R., T. Matsukawa et J. Petersen (2005), "Local Financing for Sub-Sovereign Infrastructure in Developing Countries: Case Studies of Innovative Domestic Credit Enhancement Entities and Techniques", Discussion Paper N°1, Infrastructure, Economics and Finance Department, The World Bank, 67 pages

<sup>6</sup> NALAS (2011), *Guidelines on local government borrowing and recent development in NALAS countries*, NALAS, 155 pages

<sup>7</sup> Cox E. and K. Schmuecker (2013), "Beyond Banks and Big government: Strategies for Local Authorities to Promote Investment", Northern Economic Futures Commission, Report, IPPR North, 23 pages

extent of academic research articles<sup>8</sup>. All of these case studies have been produced after 2005 and most of them only allow illustration of one given situation at a given time.

The diversity of cases handled here allows for a wide geographical coverage, with mismatched references to communities of advanced countries and emerging and developing countries at the same time. This approach does not claim to be a comprehensive nor weighted representation. It is not a definitive diagnosis. It would be more of a reasoned survey and a perspective look at local situations, revealing a common set of problems. It also allows for addressing the diversity of territorial organizations through the various forms of sub-national governments (municipalities in Cape Verde versus Lagos State in Nigeria) and the variety of types of investments implemented by these communities (financing of a waste incinerator in Poznan, Poland, financing of high schools in France by the department of Seine Saint Denis or financing of highways and sidewalks in Tunisia). This diversity also provides case studies in countries at various stages of decentralization and in local governments with various degrees of financial autonomy. For example, two extremes are the Tunisian authorities with limited autonomy in a devolutionary logic on one hand, and on the other hand the variable degrees of responsibilities devolved to sub-national governments in the United States. In the end, this diversity allows one to consider many modes of funding - without claiming to be exhaustive - ranging from bond issue (Johannesburg or even Bucharest) to different forms of contracts of public-private partnership (with, for example, the BOT of Lahore, in the Punjab province in Pakistan, or the concession contract regarding the provision of water in Senegal) passing through guarantee mechanisms - bond guarantee of USAID Development Credit Authority in Macedonia; bond guarantees to the Philippines by Local Government Unit Guarantee Corporation (LGUGC) and *bond banks* (Kommuninvest in Sweden or the Communal equipment funds, FEC, in Morocco).

The database created from these case studies is available on the website of UCLG Committee on Local Finance for Development. It is to be compared with the inventory carried out in the framework of the study component dedicated to land and real estate valuation. It should be noted that it presents several limitations:

- Firstly, most of the case studies that have been conducted represent “success-stories” of local mobilization of financial resources, with only a smaller number analyzing the reasons for difficulties and, in some cases, for failures encountered in some cases.
- The second limit lies in the increasingly blurred financial intermediation regarding the supply of financing. The divisions that could be drawn, for example, between deposit banks and capital

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<sup>8</sup> See bibliography

markets banks, appear increasingly dubious: for illustrative purposes, a Swedish community can both finance itself directly on the bond market and borrow from Kommuninvest, a bank which is itself financed on the bond markets. These overlays of “sources of funding” will explain that a development bank can be financed on the markets, or that PPP can be funded by the private sector or by borrowing from local financial institutions.

- Finally, a third and less significant limit to be emphasized: the majority of case studies we have worked on do not concern one local government in particular, but rather local governments as a whole in a given country, sometimes limiting the information available or rather their exactness.

While producing the database, we chose an approach aimed at analyzing pairs between "request for funding/financing offer" (for example, Johannesburg/bond issues or Moroccan communities/credits granted by the FEC), to give an account<sup>9</sup> of the current situation as regards the conditions for mobilization of external resources; and therefore, the conditions of meeting supply and demand.

## **II. From investment needs to the conception of funding applications**

For a local government (LG), seeking and obtaining external funding, especially when the private sector is involved, requires a number of prerequisites. From this perspective, the ideal situation would be that of a solvent community, which could ensure the economic, financial and environmental viability of its investments, and investing in projects generating income to at least cover all of the costs associated with these investments. However, by definition, even the intervention areas of the public sphere -that is to say, the financing of public goods that generate external effects and therefore social returns that are not always monetizable - this situation occurs only very rarely. In such situations, combined public and private assistance is justified.

This possibility allows for embracing a set of situations, ranging from "all public" to "all private" and to full outsourcing (or even privatization). Thus, on the one hand, we will most often find major local governments, with a solid economic base, predictable revenues and with bankable investment projects ("bankable" is a term used for a stakeholder who is bringing in money). On the other hand, more modest local governments will have difficulties launching projects that are likely to be easily financed, with not necessarily the best creditworthiness and finally for which the transaction or entry costs are more difficult to write off.

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<sup>9</sup> By opposition to a normative approach that favors "what must be" rather than "what is"

To illustrate the first type of dynamic LG, we can cite the State of Lagos, which, despite a strong dependence of the Nigerian local governments upon State transfers and a low financial autonomy, has seen its bond issues oversubscribed in 2008. These were intended to ensure the financing of contracts for public-private partnerships in the transport sector, with an income generating operation. Moreover, the State of Lagos, as well as the Nigerian communities as a whole, has oil revenues, which are a real asset compared to more standard community revenues, although volatile. In contrast, to illustrate a less favorable situation, we will see that low recourse to borrowing to finance investment from Senegalese LGs is sometimes associated with their subordination to the municipal development agency (ADM), public entity and single window of communities.

The choice of the most appropriate source of external financing (or of the combination of funding sources) should intervene, at first, after the identification of infrastructure needs and investment priorities, and then during the assessment of funding needs and of the ability to bear the financial burdens of the operation (capacity to borrow, in the case of borrowing). In practice, LGs of developed countries, which have sometimes been developing these approaches for several decades, have only little difficulty in mobilizing external funding and are often capable of making the different sources of financing and institutions compete between each other. This is visible in the case studies, particularly for French, American or even Swedish LGs. In contrast, the limited development of external financing to fund investment in Morocco stems particularly from the low absorption capacity of LGs which do not manage to fulfill the whole of their investment budgets. If technical tools exist to go in the desired direction (multi-annual investment plan or PPI in French, monitoring of financial ratios, feasibility studies, etc.), these are not sufficient as regards the strong interactions between the elements that make up the creditworthiness of LGs:

- institutional framework affects income, expenditure and debt;
- demographic and economic growth of LGs influence the revenue potential and the pressure on expenditure;
- tax revenues affect the ability to repay the debt.

In addition, enabling access to external financing to LGs that, at first glance, do not appear as ideal borrowers, may create incentives for them to improve their creditworthiness.

In this perspective, the case studies we have worked on are informative from different perspectives:

- First of all, the degree of decentralization and financial autonomy appears as a key factor in

enabling local communities to convert their need for investment into funding application, in order to be able to find a corresponding offer. Thus, in Nigeria, federal organization and the administrative and political history of the country reflect a tendency toward centralization. This results in a strong dependence of local communities towards State transfers, as well as a very low financial autonomy, which constitute handicaps when recovering from under-investment situations. In South Africa, despite a relatively significant financial autonomy, the recentralization that took place during 2000 has introduced a degree of confusion in the distribution of powers between communities and has slowed down the recourse to external financing;

- Moreover, the prudential rules imposed to regulate LG access to borrowing, most often by legal means, can create the foundations of a relationship of trust between the local public sector and the private sector: for example, in South Africa, borrowing rules are intended only for capital expenditures, or last only for the life of the funded infrastructure; for the municipalities of Cape Verde, there are threshold rules defined for the annual debt service; in Colombia, rules legally limit borrowing according to the financial situation of LGs. These prudential measures constitute both an incentive for improving the quality of management of LGs in the country, but also a form of guarantee for potential private investors. In the case LGs in Cape Verde, it appears that, since 2005 and with the support provided by the French Development Agency (AFD), prudential measures are one of the triggering factors for the establishment of a real dynamic between private banks and municipalities. Conversely, an institutional framework guaranteeing the right to borrow without actually taking into account the solvency of communities - as in the case of Tunisia - provides little incentive.
- Finally, the low level of competency and proficiency is highlighted, particularly for LGs in Africa (Cape Verde, Tunisia or Morocco), to explain the difficulties to introduce and structure a funding application that can be admissible by private partners.

### **III. Instruments for external resources mobilization**

The analysis of case studies shows that local governments can improve their creditworthiness to mobilize external funding and avoid, as it is notably the case in Tanzania, LGs to be perceived by the private sector as not accountable, not creditworthy and therefore too risky to finance. It also leads us

to characterize very simply the different situations from two main criteria that are the types of investment and the types of local government:

- For investment, at one end are income-generating investments, such as the concession contract (or *concession agreements*) relative to the bus system in the city of Bogota; at the other end, there are for example social services co-financed by Albanian LGs and the Central State. Thus, social investments (generating positive external effects), are to be distinguished from investments generating their own revenues;
- For LGs, and taking into account the multifaceted aspect of creditworthiness, one can distinguish between LGs that are perceived as creditworthy, as assessed in terms of the risk of non-repayment of debts that the community presents, and those with lower creditworthiness.

In the remainder of this section, this simple classification must allow association of the various forms of external financing with types of investments and of LGs to be funded.

Once this is clarified, it is now appropriate to look in detail into the sources of external funding identified in the practical cases. The case studies observed for this report allow us to deal with five main categories of external financing mechanisms: (i) subsidies, (ii) grants, (iii) loans, (iv) guarantees, and (v) public-private partnerships.

### *3.1. Subsidies and grants:*

Grants are either financial aid allocated to local governments, or non-repayable funding, invested and managed by local governments. Like grants, donations are non-repayable funding, assigned by individuals, philanthropic foundations or non-governmental organizations in a discretionary manner.

These external resources suffer from two major disadvantages: (i) they are most often allocated on the basis of predefined objectives and their use and destination are not left to the discretion of the local authority; (ii) they are naturally volatile sources of funding; they require (iii) lengthy and complicated procedures. As shown in the case study on the Albanian municipalities, it appears that prior to 1993, the large majority of their funding came from major international donors such as the World Bank. In order to increase and diversify the basic principle of this external funding, the Albanian Development Fund (ADF) was then established.

Grants and subsidies are proving particularly well fitted to LGs with relatively low creditworthiness, and for social investments that do not generate income. In this framework, this funding - as it is also the case for development assistance or sometimes for the intervention of national banking institutions - can play a trigger and lever role, by encouraging LGs to improve their creditworthiness and attract private investors. In this sense, investment grant policies must have an incentive to allow public authorities (national or sub-national) to invest in priority sectors, usually difficult to finance. For instance, as an upgrade of the European Union structural funds, a grants policy must be mobilized to create an impulse, in order to play a lever role or give time to the local government funded in this way, to strengthen its own capacities. In a system with public co-financing, the leverage effect of research must trigger participation for other stakeholders, thereby reducing the workload of the project leader. To be effective, it appears that any grants system must be accompanied by a clear vision of the object to be financed in order to attest the conformity of expenditure, by a simplification of allocating and sharing mechanisms, and by a clear readability of beneficiaries at the local level. This is all the more true as grants and subsidies are not a perennial source of funding – e.g. grants from major international donors are dedicated to last only over a given period of time. Finally, to be effective, any grant or subsidy must be seen as a financing mechanism among others, to avoid the pitfalls of the "grant culture."

### **3.2. Borrowing and guarantees**

Borrowing – under the various forms it can take, and that we will distinguish, constitutes a financing mechanism adjusted to a wide array of situations: in South Africa, either for the relatively financially viable large metropolitan governments, or for smaller rural authorities, access to borrowing is a privileged mode of external funding; Colombian LGs are also financed by borrowing, just as American LGs; finally, it should be noted that the PPP arrangements for colleges of the department of Seine Saint Denis in France has been set up through borrowing.

Here we distinguish five forms or “tools” that enable local governments throughout the world to benefit from borrowing: (i) deposit banks; (ii) bond banks; (iii) government agencies; (iv) dedicated funds and (v) bond issuance. Although the boundaries between these different tools are sometimes very porous, in our view this classification has the merit of distinguishing the tools from the resources they are backing.

#### **3.2.1. Deposit banks**

The main activity of a deposit or retail bank is to perceive savings, to then grant loans and provide banking services. In this way deposit banks have an intermediary function between agents with surpluses of financing, from which resources are collected, and agents with financing needs. For this type of bank, operating on local governments' market therefore requires sufficient resources and then to be capable of managing the risks associated with the transformation of short-term cash-flow savings into funding dedicated to be, by definition, non-liquid and long-term. Public banks such as the *Caisses des Dépôts et Consignations* in France and Senegal (CDC), or in Italy (*Cassa Depositi e Prestiti*), operate on this model. However, involvement of private sector banks appears more difficult.

If this type of lender is rare on the credit market for local governments, this is particularly because only a small number of local governments can have their deposits and savings picked up by banks, thereby allowing commercial banks to lend them funding on the basis of their own deposits. The only example of this type that we are aware happened in Belgium, between local governments and the *Credit communal* of Belgium - before it was absorbed by Dexia bank.

Furthermore, mobilizing the commercial network of private banks well-established at the local level may be necessary in the hopes to reach as many local governments as possible and therefore enable them to access funding for their investments. From this point of view, the case of Colombia and Germany are relatively informative. In these two countries, commercial banks are mobilized to allot resources which they would not have had otherwise at their disposal to finance local governments:

- In the German plan, *Kreditanstalt für Wiederaufbau (KfW)*<sup>10</sup> provides liquidity at low interest rates and on long maturities to commercial banks to cover the loans that they will grant. So banks appear to be one of the elements of a solution to financing the German economy, in doing what they are made for: assess risk and make profits. Thereby KfW benefited from the expertise of the banks and, in return, these can cover a segment of the market that they would not have been able to cover without it;
- In Colombia, *Financiera de Desarrollo Territorial (FINDETER)*, like KfW, does not lend directly to local authorities, but it rolls over the loans granted by banks to these same local government units: the eligible banks can thus secure their resources, having the possibility to borrow up to 85% of the value of the loan from FINDETER on the same maturity (over 12 years).
- We can also mention the *European Investment Bank (EIB)* which practices this type of

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<sup>10</sup> German public bank.

intermediation, particularly in order to cover a broader perimeter and to finance more local governments.

- Finally, the example of Cape Verde is very interesting in this aspect. Before 2005, Cape Verde's 22 municipalities were struggling to finance investments through commercial banks other than commercial equipment (cinemas, malls, etc.). Due to scarce and short-term resources (low-rates of remuneration on deposits), banks were not inclined to take the risk of financing local governments, often showing a lack of competencies. Therefore, incentives must be created for banks to lend funding, by providing them with the adequate resources. In this way, in 2005 the AFD passed a liquidity agreement with three of the four main commercial banks, Banco Commercial de Atlantico (BCA), Banco Interatlantico (BIA) and Caixa Economica do Cabo Verde (CECV). The agreed line of credit allowed them to cover financial needs in sectors devolved to municipal authorities<sup>11</sup>, with durations of over 5 years and with more competitive interest rates. This model has triggered a dynamic at the local level, with municipalities wishing to develop their relationship with banks, and a fourth bank volunteered to be involved in the process.

When the AFD will decide to end the liquidity agreement, the plan abovementioned will question the sustainability of banks interfering in local government access to funding. Nevertheless, it shows that development aid can play a trigger role to make supply and demand meet. This last point also shows that without adequate resources, the traditional private banking system has difficulty responding to long-term investment needs of local governments. This is further emphasized by prudential regulations imposed on banks, particularly in developed countries.

### **3.2.2. Bond banks**

Traditional deposit banks must sometimes be supported by other financial institutions in order to have the resources adapted to local governments' financing needs. In our previous examples, the common ground for institutions such as KfW in Germany and FINDETER in Colombia is that a vast majority of their resources come from their own bond issuances on the financial. Subsequently, we will refer to these institutions as "bond banks".

A bond bank can be defined as a financial intermediary that borrows from financial markets, in order to loan to local governments based on these resources. The generic term "bond bank" gives the idea

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<sup>11</sup> Sanitation, rural development, health, housing, land transport, education, social development, culture, sport, tourism, environment, trade, civil protection, employment, vocational training, police and municipal investments.

of a pooling of loans to communities in order to create a portfolio which allows for economies of scale and diversifying the associated risks, in order to ensure the creditworthiness of the bank itself.

Besides KfW and FINDETER, there are some institutions whose mandate allows them to directly grant loans to local communities, such as the FEC of Morocco, the Development bank of South Africa (DBSA) and the Infrastructure finance corporation limited (INCA) in South Africa, the Urban development bank in Nigeria, the Tamil Nadu urban development fund (TNUDF) or the Kommuninvest in Sweden.

Bond banks differ from deposit banks in different ways. First of all, they are more apt to financing long-term investments, since they are able to receive long-term savings on bond markets. Another advantage of bond banks is that they can diversify the sources of financing by issuing on both national and international markets. They can also frequently benefit from funding from large international backers. A third key point is the market discipline imposed on these bond banks. Since while they raise funds on the market, they must win and maintain the trust of investors. This often occurs through rating assessment, most often of high-quality. This also suggests sound management of credits lent to local governments, and less default rates. This situation is facilitated by the diversification and therefore pooling of risks. Also, these banks specialized in local governments' financing develop over time a real expertise that reassures investors.

If these elements appear very positive to obtain an offer of long-term loanable funds, they also present some advantages for local governments:

- Pooling allows a specific investment project to be supported with a level of creditworthiness homogenized for local governments as a whole. This can therefore allow for some leeway with regards to how a particular investment project would be analyzed based on the human and financial capacity of one community on its own. At the same time, this mechanism opens the door to long-term savings for local governments which, due to their small size, could not necessarily have access to it.
- Moreover, these institutions are often pioneers in the building of local governments' financial expertise, as well as in the production of knowledge in specific sectors. The FEC, for example, provides Moroccan municipalities with technical assistance throughout the investment process; the UDB in Nigeria provides technical support to structure financial arrangements, carry out training and operations, and is involved in national commissions; FINDETER plays a guidance role for Colombian municipalities, like Kommuninvest in Sweden;

- Finally, an important aspect of these bond banks is that their shareholding can be private (e.g. INCA in South Africa), public, or even formed by the local governments themselves. If the FEC in Morocco is a public institution, chaired by the Minister of the Interior, Kommuninvest in Sweden is majority owned by the local governments. In such a case, local governments were able to create their own bank, receiving benefits from the system of bond banks, while being in charge themselves of designing the strategy of the bank. If this model is the subject of enthusiasm with the recent creation of institutions of the same kind in France or the United Kingdom, it requires local governments to unite, to then implement financial engineering that they do not already have. However, possibilities of shared ownership together with the Central State can allow the latter to support local governments on the path to financial accountability, by enabling them to gain more independence and financial autonomy<sup>12</sup>. It therefore shows that this type of initiative can create a virtuous circle, where communities can create their own bank to finance more projects and boost the local economy thereof, while at the same time improving the creditworthiness of each municipality. As we will see later, these initiatives can be accompanied by guarantee mechanisms, able to further reassure investors.

### **3.2.3. Government agencies**

The third type of tool that we would like to highlight here is government agencies. In contrast to bond banks, government agencies have little or no recourse to capital markets to mobilize resources. They derive most of their resources from the State or local governments' budgets (in the form of grants and other types of transfers). The Caisse de prêts et de soutien des collectivités locales (CPSCL) in Tunisia, the ADM in Senegal, the Local Government Loans Board in Tanzania or the Albanian development fund in Albania operate on this model. Even though most of these institutions lend to local governments in the form of repayable loans, as bond banks do, they more often operate in largely centralized countries, such as Tunisia or Senegal, characterized by systems of devolution.

From the case studied here, bond banks appear to be implementable in a wide array of decentralization contexts, with the capacity to accompany the decentralization process. On the other hand, government agencies seem less flexible and operate in contexts where municipality dependencies regarding the State and its resources remain important, with limited financial autonomy and a low capacity to manage the determinants of its own creditworthiness. These

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<sup>12</sup> The issue of ownership should not be overlooked, as shown by Dexia's history in Europe.

agencies should be more perceived as relays of the State for the implementation of public policies, rather than financial institutions in the full meaning of the word.

Then, the difficulty is that there are few incentives, both for local governments and the institutions, for virtue and quality management. This lack of incentives may sometimes even be translated as a form of disempowerment. In Senegal, the proliferation of these types of agencies has multiplied the impediments to local governments' access to borrowing for investing. The virtuous dynamic of capitalization of local governments' investment capacities has never really been set in motion. For example, the ADM was perceived as a mere executing agency much more than as a flawless financial partner.

#### **3.2.4. Special funds**

A special fund is an ad hoc entity (or *special purpose vehicle, SPV*), created with a specific objective which will determine its actual lifetime. The ad hoc entity then grants loans or guarantees to local governments whose investments fall within its field of intervention. In this sense, these funds get closer to bond banks, in that they raise funds on bond markets; on the other hand, they are distinct in that they do not fund all types of investment, but only those falling within their field of intervention.

Such funds are established in particular to finance income-generating activities, rather than activities expected to generate where positive externalities. Indeed, they are less compatible with the pooling of a variety of local governments and projects than bond banks; but conversely, they have a more precise field of expertise.

These ad hoc entities can also acquire holdings and make capital investment thereof. These types of funds are found notably in the Philippines, with the Local Government Unit Guarantee Corporation (LGUGC). The LGUGC is a financial services firm whose shareholders are predominantly made of commercial banks and government financial institutions. On the basis of this capital, and with a co-guarantee agreement with USAID, the main role of LGUGC is to promote community access to the bond market by guaranteeing the issuances that are carried out.

The loan guarantees are intended to protect creditors from the risk of non-repayment of the debt. Therefore, it is a form of insurance which allows enhancement of creditworthiness and reduction in its cost. The guarantee may be provided by a higher level of government, by local governments

themselves, by international organizations or even by the private sector. In the case of appropriation of income, the guarantee can be based on the ability, in the event of payment defaults, to directly receive the income generated by the entity that is the subject of the guarantee. In this way, LGUGC also seeks to promote private sector financing of local governments, by reducing the risk associated with each individual transactions.

One of the main interests of this mechanism is clearly to allow investors to grant loans to the local governments with which they were not used to deal with; and therefore to help connect supply and demand. Indeed, by providing its guarantee, LGUGC simplifies the lives of investors, reduces the cost of entry into a new market and limits the associated risk. Loan guarantees, aimed to facilitate the financing of rail investment in the form of PPP in France, have also proven to be useful tools for securing the trust of commercial banks and facilitating their involvement in the project. In Macedonia, the loan guarantee provided by USAID Development Credit Authority to the municipality of Karposh also appears to have been a trigger, just after local governments had been enabled to access to borrowing in order to ensure financing of their investment. Thus this USAID intervention is a good illustration of a process of capacity-building. First, by stressing that before the borrowing procedure, technical assistance from USAID-Macedonian Local Government Activity (MGLA) has allowed the implementation of a self-assessment system of creditworthiness, including a prospecting tool based on past budgetary trends and income/expenditure scenarios; second, by creating a successful dynamic of cooperation between various actors, being USAID and the municipality of Karposh, but also the association of municipalities, energy service companies and the Ministry of Finance. Finally, by creating a new dynamic of local financing, it allowed some municipalities to make themselves known to the banking sector as creditworthy.

### **3.2.5. Bond issues**

A bond is a loan issued by a local government in the form of debt securities - bonds - purchased by investors. These bonds are most often negotiable and are in individual denominations corresponding to a portion of the total borrowed amount. Bonds provide for the payment of interest, usually on an annual basis, and ultimately a reimbursement upon maturity, in fine.

Among the cases studied in this study, the city of Johannesburg in South Africa, the State of Lagos in Nigeria, the city of Bucharest in Romania, the cities of Koprivincia and Rijeka in Croatia or even Filipinos local governments have issued municipal bond. Whereas bond banks allow the pooling of needs to allow a greater number to benefit from funds raised on capital markets, bond issues carried

out directly are still the preserve of largest local governments, as shown notably in the case of South Africa, Nigeria and Romania. In western Europe, where this mode of financing is used for many years, it also remains the privilege of the largest local governments, regions and departments in France, regions and provinces in Italy, cantons in Switzerland, regions in Belgium, länders in Germany, etc.

Indeed, the average amounts of bond issuances still remain high, with a threshold of approximately 500 Million ZAR<sup>13</sup> for Johannesburg, an issuance of 500 M€ for Bucharest in 2005 or an issuance program of 275 Mds NGN<sup>14</sup> for the State of Lagos. In Europe, even though average amounts issued are set lower (e.g. for the cities of Koprivina and Rijeka in Croatia, minimum issuance was set at 8 M€), other constraints limit access to the bond markets, on a global scale, to the most important local governments.

Among these constraints raises the necessary - but not always legally mandatory - rating by an independent agency (AA and A+, for example, for the State of Lagos from three rating agencies: Fitch Ratings, GCG and Augusto & Co); occasionally significant transaction costs must be written off by the amounts issued (attorney fees, arrangement fees and other placement committees). Besides, the mobilization of a highly skilled financial management team is necessary, in particular for producing the financial documentation to be sent to investors. This means that bonds directly issued by local governments are carried out by those with good or very good creditworthiness, or at least with a strong readability for investors.

Such local governments are most often found in countries with advanced decentralization and relatively high financial autonomy. When this is not the case, such as in Nigeria, other qualities and attractive assets should be valued towards private investors. In the case of Lagos, the pool of oil revenues available, enriching the State thereof, allows the State to leverage funding on the bond markets. Conversely, it has been proven that these local governments have to accept and comply with the market discipline imposed upon them, while allowing them to draw profits in return. Thus, bond issues do have certain benefits, such as the diversification of funding sources and the mobilization of long-term savings for placement issues: in the case of Lagos State, demand has been stronger than supply, as previously mentioned, illustrating the fact that there is a stock of saving available for local public investment projects; in Bucharest, the bond was issued on the London Stock Exchange, as an alternative to local credit market and international financial institutions (EIB, EBRD, etc.) both unable to answer this need. Mobilizing local or international savings on its own appears

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<sup>13</sup> 33,524 millions euros (Sept 2015)

<sup>14</sup> 1,217 billion euros (Sept 2015)

also to be a significant advantage for local governments, enabling them to communicate around these successful experiences.

#### **Bond issues**

**In South Africa**, April 2004 was a "historic moment" for the city of Johannesburg and its Mayor, Mr. Masondo, with the successful launch of the first bond issue of the city. Since then, the city issuance program ("Domestic Medium Term Note") has enabled to issue nearly 6 Bn ZAR of bonds.

**In Germany**, June 2015 has been the opportunity for the municipalities of North Rhine-Westphalia to conduct their third "communal" pooled bond issue. 250 million EUR have been raised by five municipalities: Bielefeld, Essen and Remscheid (20% each), Gelsenkirchen (24%) and Hage (16%). This pooled bond issue has been conducted over a maturity of 7 years with an interest repayment of 1.25%. The previous issuance of this type was achieved in February 2015 and comprised of 6 cities, for an amount of 500 million EUR, raised on 10 years, at 1.15 %.

Finally, the case studies analysis reveals that the market discipline that underlies bond issues, bond banks or even commercial banks, is to generate a virtuous cycle: access to credit is reflected by the improvement of local governments' creditworthiness. On one hand, investments financed thereof contribute to the local economy, with positive externalities on local governments, while on the other hand local governments endeavor to make financial data and information transparent and available to investors. Thus these tools appear as incentive mechanisms allowing the private sphere to take the risk of financing investments which sometimes go beyond their favorite sphere of action.

### **3.3. Public-private partnerships**

The last tool discussed here for enabling local governments to finance their investment, particularly in matter of investments in infrastructure, is the public-private partnership contract. By very definition, it is the association between local governments and the private sector by involving the latter in investment projects regarding the public sector.

These partnerships are established in order to deliver public services to meet customer and user expectations, while transferring a portion of the risks to the private partner or operator. Among the case studies already mentioned, Lagos State in Nigeria has put in place an exclusive bus lane (Bus Rapid Transit), carrying 150,000 passengers per day, allowing for a 30% tariffs decrease and a 40%

reduction in journey times. Private operators have been in charge of the operation of the line, in the framework of a partnership with the National Union of Road Transport. The city of Bogota has also funded a bus network via a concession contract. Lahore, in the province of Punjab, has financed its first composting/recycling plant via a public-private partnership contract. In France, the city of Marseille and the Department of Seine Saint Denis have respectively funded the rehabilitation of two stadiums and 3 lots of 4 colleges by this mean. Regarding Central States, which have proved to be important PPP actors, many investments are financed through this tool, such as a water network in Senegal, motorways around Santiago de Chile, as well as in Tunisia Anakapali in India, an institute of higher education in Singapore, or high speed train lines in France.

A first finding is that this mode of financing is primarily used for investments that generate revenues, justifying the intervention of the private sector and allowing private and public interests to converge. As soon as a significant transfer is made to a private body, the public entity must ensure the financial viability of the project, which may require some upstream adjustments (rising of tariffs, compensations of social tariffs, incentives, etc.). In this regard, the case of the water network of Senegal is quite exemplary.

A second observation is that the more the risk is transferred to the private partner, the more local authorities are "distanced" from the project, and the less they are in control of the operation. They have a role to play in financing (through providing grants, guarantees or other type of support to the project) but do not bear the risks related to construction or delivery. Following the degree of risk transfer, four types of tools can then be distinguished:

1. The *public contracting ownership*: public and private entities are working together but the contracting owner remains public, which constitutes the main advantage of this formula. On the other hand, this a minima outsourcing leaves the public entity, the contracting owner, with a significant share of the risks related to realization and maintenance, including lengthy and rigid procurement procedures, with a direct budgetary impact;
2. *Mixed companies held by the public sector and the private sector*: a company with public and private capital is created. The advantage of this system is that it combines the flexibility of management of private companies while leaving control of decision-making in the hand local communities, even though the transfer of risks is limited;
3. *Project funded initiative or build/operate and transfer projects*: contract by which a local government entrusts a third party with an overall investment mission. Within the partnership contract, risk sharing tends to be more optimal, particularly with the transfer of the construction

costs.

4. *Concession agreements*: concession is a management approach by which the local government devolves upon its counterpart responsibilities from building to operation of the service at its own expense, for a given period of time. The main advantage is the transfer of operating risks from the public to the private entity, hence a faster realization phase, and a lower impact on the public budget.

The mastery of engineering is another key factor of success, whether seen as purely technical engineering, for the construction of a work of art for example, or through a more qualitative engineering logic, such as socio-economic analysis that provides a comprehensive vision of a given problem. This local expertise is essential for the design and follow-up of contracts, for ensuring deadlines are respected and assess the good-functioning of service or delegated investment, and avoid financial losses. In cases where public donors do not have these skills internally, they must ensure to be accompanied by specialized advisers with no conflict of interest for the project. In the case of Bogota city, political, technical and administrative expertise, notably resulting in true municipal leadership and therefore a strategic long-term vision, has fully contributed to the success of the BRT project.

Finally, the level of development of the territory is a determining factor for attracting private investors on local public equipment. These are in fact concentrated in developed and emerging economies, politically stable, with clear regulations and an ability to control the projects with structured teams. In this regard, the level of decentralization is also a favorable factor in the deployment of PPP, the local communities therefore have regulatory autonomy and a sufficient budget to implement direct means of project funding. On the other hand, for centralized countries, the State generally focuses on structuring projects at national level, which can certainly allow a few economies of scale, but only allows marginal adaptation of services to the needs of the land. In this regard, note the interesting experience of Uganda, who with the support of the PPIAF, developed a national strategic plan in favor of PPP, aiming to secure and reassure financial and industrial investors, while facilitating the access of local communities to this type of tools.

## **I. Preliminary conclusions and proposal of recommendations for local governments:**

- 1/ Decentralization and financial autonomy are favorable for mobilizing external financing resources
- 2/ The legal and/or prudential framework must increase confidence and quality of local governments creditworthiness
- 3/ Enhancing debt and credit relationship can improve local governments' creditworthiness and the sustainability of projects to be financed, from all angles (financial transparency, financial management, project design, etc.)
- 4/ Beyond the basics, adjusted safeguard measures should be considered to decrease the perceived risks of local governments and/or projects, and increase the trust from the private sector.
- 5/ « Pooling » of needs is a concrete way of mobilizing more numerous external sources of funding.
- 6/ Grants, subsidies and various forms of development aid must be used as a signal to leverage additional sources of funding, in particular from the private sector.

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