5 FUNDAMENTAL RECOMMENDATIONS

BY UCLG FOR LOCAL FINANCES TO MEET THE NEEDS

Meeting the Challenges of Development:
Local Governments with Adequate Financial Capabilities

UCLG Committee on Local Finance and Development

INTRODUCTION

The adoption of a new urban agenda at the Habitat III summit in Quito followed a long series of international negotiations. During this an overall consensus was reached on the **economic, social, and environmental challenges** that we face, as well as the development goals the international community wishes to achieve by 2030.

The **effective implementation** of public policies that allows for the addressing of these issues implies a considerable financial effort. Different studies carried out showed a need to **double, or even triple**, the average amounts budgeted for collective urban investments. Within a context where the majority of investments are the responsibilities of local governments, increasing their scale is necessary for substantial reform of local financial systems.

Today, the **overall structural imbalance** between powers granted to local authorities and their resources has serious consequences on the quality of life for residents of cities and territories. How can the necessary **changes of scale** be implemented? What potentials can be developed? What are the conditions under which local resources can be mobilized to finance sustainable urbanisation?

United Cities and Local Governments, through its Committee on Local Finance and Development, has maintained a continuous debate among its members on the issue of local finances. Along with the aid of a comprehensive study (see Appendix p.14), a fair number of **fundamental principles** have been identified on which the 5 key recommendations detailed further in this document have been based.

I wish you an insightful reading, and for those who wish to explore further, numerous reports and notes that delve deeper into this topic are available on the Committee's website:

www **uclg-localfinance.org/fr/publications-summary**

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RECOMMENDATIONS

1

PROMOTING A FAVOURABLE ENVIRONMENT FOR LOCAL GOVERNMENT ACTION

Making financial decentralization effective and efficient

2

MOBILIZING THE ENDOGENOUS WEALTH OF CITIES AND TERRITORIES

Rethinking local financing systems to make them sustainable

3

CHANNELLING GLOBAL SAVINGS TOWARDS THE LOCAL LEVEL

Long-term access to external resources in order to finance investments and respond to urgent needs

4

ACHIEVING A LEVEL OF LOCAL RESOURCES THAT REPRESENTS 20% OF NATIONAL ONES BY THE END OF THE NEXT DECADE

Within developed countries where local resources have reached this goal, local governments can assume close to 2/3 of public investment

5

CREATING A GLOBAL, MULTI-PARTNER OBSERVATORY ON LOCAL FINANCES

Monitoring the financial capabilities of local governments in helping them achieve the sustainable development goals

1

PROMOTING A FAVOURABLE ENVIRONMENT FOR LOCAL GOVERNMENT ACTION

MAKING FINANCIAL DECENTRALIZATION EFFECTIVE AND EFFICIENT

1.1. Achieving financial decentralization

The financial capabilities of cities and territories are largely dependent upon the **performance of financial decentralization systems in place** within a country. In regards to this, national governments occupy a fundamental role in creating a suitable environment for collective local action and the mobilization of relevant resources.

The European Charter of Local Self-Government and international guidelines on decentralization outline a series of common principles to be adhered to in the implementation of local finance systems:

- **The principle of proportionality (financing relevant** jurisdictional authorities)
- **The right to adequate revenues** (the existence of margins for autonomy on revenues)
- **The limited use of conditional intergovernmental transfers** (in favour of unconditional transfers)
- **The principle of solidarity** (equalisation payments between territories)
- **The right to borrow in order to finance investments in infrastructure**

1.2. Fighting against corruption in order to finance development in cities and territories

With regards to public national and local finances, corruption accounts for a **substantial loss of revenue**. Proactive public policies used to tackle this issue are defined by **transparent public financial management**, and a need for **accountability on behalf of citizens** that should also enable to mobilize substantial amounts for the benefit of development.

The mobilization of local resources must be able to rely upon a certain number of tools made available to local governments

1.3. Putting effective instruments in place for the exercise of powers

These instruments vary widely and their performance depends directly on the context in which they are used. With regard to taxation, for example, it was noted that the existence of **land registers, digitised or not**, formed an essential component of property tax returns. Additionally, development plans that capture a portion of the added-value generated by public investments must be able to rely on an **appropriate legal corpus** that is consistent with existing property rights. Given the increasing involvement of private actors in the management of urban services, and the existence of specialised operators such as **local public companies**, on an institutional level this area represents an important way to ensure the sustainability of such services.

Developing local capacities constitutes a major challenge that must be addressed for decentralization to be effective

1.4. Strengthening human capacities in local governments

In an increasingly complex environment with a growing number of rules and regulations, also characterised by the involvement of multiple actors, it is vital for local governments to develop financial engineering.

Qualifying training courses and the promotion of innovation through the exchange of experiences among peers are essential elements for development in this area.

As experts in their field, financial directors of cities measure the day to day strengths and weaknesses of legal, institutional, and financial frameworks of decentralization. Their analysis supports UCLG's advocacy on the international stage. In return, debates between peers are initiated on various topics of local governance, which lend real support to their everyday practices.

UCLG drives a global network of financial directors from municipalities

2

MOBILIZING THE ENDOGENOUS WEALTH OF CITIES AND TERRITORIES:

RETHINKING LOCAL FINANCING SYSTEMS TO MAKE THEM SUSTAINABLE

2.1. Granting a sufficient degree of local autonomy

Responding to growing needs implies that local governments have sufficient financial autonomy to mobilize a portion of the wealth produced in their region, thanks in particular to public investments and infrastructures available to economic actors.

Cities concentrate the majority of economic growth, bringing together production factors, and putting networks of public infrastructure into place so as to generate agglomeration economies. However, legal frameworks often provide no mechanisms for guaranteeing returns on investments that are sufficient to ensure sustainable financing for urbanisation. In order to develop a "city financed by the city", it is necessary to strengthen and broaden local taxation, as well as to equip local authorities with instruments for capturing part of the land added-value generated.

A sufficient level of financial autonomy should allow for the adjustment of revenue needed for expenditure requirements, including a portion of the increased value that is created through local public policies and investments

Land and property value capture has long played a key role in financing urban development

2.2. Reinforcing and diversifying local taxation

Taxation makes up one of the principal mechanisms through which public authorities are able to draw on a portion of generated wealth. However, the large majority of taxable goods are often appropriated by the national level of govern. This leaves local authorities with **narrow tax bases that are also highly dependent on property tax**. Therefore, **a diversification of local tax bases is necessary**, specifically through the devolution of all, or part, of high-yield taxes, as well as a local authority for modulating tax rates.

2.3. Developing land and property valuation

Cities like New York, London, Paris, and more recently some cities across China, have made of land and property value capture a significant component of infrastructure funding. Different financing tools related to this prove to be **particularly well-adapted to cities that are growing rapidly**. However, their use in a number of cities remains considerably lower than their potential, while current and future needs remain substantial. Nevertheless, these instruments must be accompanied by legal regulations and participatory mechanisms, including compensation, with the aim of avoiding rent collection solely by local elites, as well as resisting the pervasive effects of financialization of the city.

2.4. Financing local public services

Guidelines by UN-Habitat on decentralization and access to basic services put local communities at the heart of development and the provision of these services. However, their limited financial elasticity, composed structurally of tariffs, taxes and transfers, is insufficient for responding to growing needs. Therefore, in the short term, it is essential:

- **to reinforce the use of bridge financing and, more broadly,** financial intermediation mechanisms with better reimbursement abilities

- **and/or to earmark a portion of national wealth to expand these services.**

3

CHANNELLING GLOBAL SAVINGS TOWARDS THE LOCAL LEVEL:

LONG-TERM ACCESS TO EXTERNAL RESOURCES IN ORDER TO FINANCE INVESTMENTS AND RESPOND TO URGENT NEEDS

3.1. Pre-financing investments through loans and/or PPPs

The urgency and scale of the needs to be met involve the use of financial tools with a **multiplier effect**, such as loans and public–private partnerships, which allow for reimbursement of investments to be stretched out over time. However, the legal and supervisory structures that allow local governments to use this type of financing are not always in place.

- **With regards to loans,** another determining factor of local authorities' reimbursement capabilities is the presence of specialised financial institutions. Such institutions pool their resources together as well as the associated risks, proving that under certain conditions, they are perfectly adapted instruments for facilitating long-term access to external resources.

- **Public–private partnerships,** on the other hand, are primarily used for revenue-generating investments. Their existence is concentrated within politically stable, developed and emerging countries with clear regulations, and a capacity to oversee projects thanks to well-structured teams.

3.2. Establishing guarantee mechanisms favouring local authorities

Despite the exceptionally favourable financial conditions for long-term investments (low interest rates and an abundance of capital savings), investments in infrastructure and urban services, are in fact not a priority for public or private investors.

In many countries, **mechanisms to secure investors, as well as donor incentives**, are subsequently necessary for funnelling global savings towards the local level. If accompanied by measures for strengthening local institutional capacities, and perhaps even by national reforms, the development of guarantee mechanisms for investors seems necessary nowadays. These mechanisms have a cost, yet they represent a strategic means for states that are relying on official development assistance and climate finance to be able to leverage sufficient capital.

3.3. Involving Official Development Assistance and climate finance in cities and territories

Currently, sustainable development of cities and territories is facilitated largely through public policies and through investments implemented by local governments. **However, these emerging actors in development are not yet adequately recognised** by development banks or by dedicated climate funds. Few of them directly finance local municipalities or have a true understanding of their specific functions.

Yet, during the transition period faced by developing countries, they could be able to **divert international funding to the territories where it is most needed.** Specifically, this involves playing a coaching role with regards to investors and financial markets. Furthermore, such support is likely to act in favour of national reforms, as well as strengthening local governments' capacities, which are vital in underprivileged settings.

This brings into question the ability of modern financial practices to reconcile high demands for short-term performance with long-term joint investment, despite creating positive externalities and added value

The degree of decentralization and financial autonomy appears to be the key factor determining local authorities' access to external resources over the long term. Furthermore, given that their initiatives can draw from their own resources, they are likely to be able to withstand external shocks

4

ACHIEVING A LEVEL OF LOCAL RESOURCES THAT REPRESENTS 20% OF NATIONAL ONES BY THE END OF THE NEXT DECADE:

WITHIN DEVELOPED COUNTRIES WHERE LOCAL RESOURCES HAVE REACHED THIS GOAL, LOCAL GOVERNMENTS CAN ASSUME CLOSE TO 2/3 OF PUBLIC INVESTMENT

*Source: UCLG Global Observatory on Local Finances – in collaboration with the OECD - Assembled by sub-national governments outside of federated states.

4.1. Equitable sharing of domestic resources between different levels of government

While local governments around the world must constitutionally assume the responsibilities associated with essential components of development, the distribution of domestic resources between different levels of government is still often inequitable and inadequate.

The proportion of domestic resources allotted to local governments averaged ***6.7% in least developed countries as compared to 23.5% in developed ones****, where local governments are in return able to provide close to 2/3 of civil public investment.* *

4.2. Structuring a multi-level governance framework that includes civil society and the private sector

Agreeing upon local resources which are sufficient for exercising the powers entrusted to the local level involves **looking for synergies**, as well as structuring dialogue among central governments, local governments, civil society, and economic stakeholders. In this context, the existence of a multi-level governance framework must be based on local governments' transparency and accountability towards civil society and the private sector. Furthermore, it is essential to ensure consistency across national priorities, and the territories' specific needs.

National associations of local authorities must be able to meet regularly with central government agencies responsible for local finances. They must also be involved in preparing laws that have a local impact. In view of this, several countries are establishing institutions or mechanisms for facilitating this dialogue, including national committees on local finance, either with or without National Observatories on local finances (see recommendation no. 5).

4.3. Assessing transferred responsibilities

The lack of clarity and stability in the distribution of powers across different levels of government prevents them from identifying the territories' needs accurately. This situation is often exacerbated by the fact that local authorities' jurisdictions do not necessarily correspond to the area and perimeters of economic and residential development, or natural resource management.

Among the factors accounting for local financial imbalances, is that of the territorial division of countries into local authorities. The latter have no reason to coincide with the constantly evolving landscape of economic and local residential development. The landscapes of "recurrent local costs" and "recurrent local resources" are often disjointed. Therefore, multiple spill-over and cross-over effects occur across municipalities.

4.4. Ensuring predictable, stable, and incentivizing financial transfers

Financial transfers by national governments are often one of the main resources for local budgets. When they are predictable and stable, they contribute to the financial capacity of local authorities in implementing long-term public policies. Additionally, when appropriate equalisation systems are in place, such transfers contribute to **national cohesion** through their support of underprivileged regions. However, within a context of growing needs, and keeping in mind the budgetary constraints faced by a number of countries, transfers must be accompanied by local endogenous resources necessary for regional development.

Without knowledge of the costs, there can be no well-informed local arbitration, no effective provision of services and therefore no tax compliance

Decentralization may be perceived as an unattainable dream if the transfer of powers to local governments does not improve the citizens' quality of life. This is true especially if local officials do not have sustainable financial means over the long-term to effectively assume the responsibilities entrusted to them by law

5

CREATING A GLOBAL, MULTI-PARTNER OBSERVATORY ON LOCAL FINANCES:

MONITORING THE FINANCIAL CAPABILITIES OF LOCAL GOVERNMENTS IN HELPING THEM ACHIEVE THE SUSTAINABLE DEVELOPMENT GOALS

5.1. Monitoring local financial capabilities in implementing the Sustainable Development Goals

Several studies carried out as a part of the Millennium Development Goals showed that the MDGs' low level of success was strongly linked to the lack of funding that central governments provided to local governments. It was also linked to local governments' inability to access external funding while they have been devolved extensive authority over basic services delivery.

Collecting data on decentralization and local finances is not yet systematised, especially in certain developing countries where resources are lacking to implement efficient information systems. As a result, the main challenge to the Observatory is successfully building and implementing a database that is as comprehensive as possible. A preliminary study was published by UCLG, in collaboration with the OECD and the AFD (French Development Agency), which highlighted the major indicators for financial decentralization in 100 countries worldwide. This first stage of the project is expected to mobilize states and various partners around the definition of a more ambitious roadmap. This includes, both in the short and long term, progressively obtaining more accurate data, and assessing better local authorities' financial capacities.

5.2. Facilitating dialogue between National and Local Governments

On a national level, the existence of transparent databases on local finances is an essential tool for supporting dialogue among different levels of government, by providing objective, comparable data on the sharing of domestic resources and their allocation.

To meet the challenges of local development, local governments must have access to instruments to have a better knowledge of the state of local finances within their country. It is necessary to be able to improve cities' investment capacities, understand their room for manoeuvre, in order to put them in relation with the rest of the country, and to detect any structural or cyclical factors that would limit their potential.

There is no universal model to be promoted outside of this large diversity, yet a certain number of basic, fundamental principles can be highlighted

5.3. Developing a community of practices and experiences on local finances

The Global Observatory on Local Finances also aims to strengthen expertise on local finances. In bringing together elected local officials, national representatives, academic experts, professionals in the field, as well as technical and financial partners, this platform for exchanging knowledge and expertise will contribute to the development of common guidelines on local finances. This will take into account the great diversity of funding systems around the world.

Whether it be a political, economic, social, historical, or cultural environment, local financial systems are directly linked to the context in which they are implemented. By bringing together municipal representatives from different parts of the world, the Observatory on Local Finances is able to facilitate the exchange of experiences, and to develop best practices while also nourishing procedures for assessment and innovation. Through this platform, local decision-makers are able to rely on their own analysis to guide the implementation of their financial policies.

The success of new international commitments favouring development will rely strongly upon strengthening and improving local finances, which the international community should have the capacity to measure

Reinforcing national advocacy in favour of financial decentralization is critical for local governments to be able to fully ensure their role as development actors

STUDY / APPENDIX

"CONDITIONS FOR THE MOBILIZATION OF LOCAL RESOURCES FOR SUSTAINABLE URBANISATION"

DAVID ALBRECHT, MATTHIEU COLLETTE, GUY GILBERT

WITH THE COLLABORATION OF CLAUDE DE MIRAS

Today, urban areas are primarily concentrations of economic activity and, to varying degrees, represent powerful machines that simultaneously generate added value for production as well as land and property. However, legitimately drawing on a part of this resource has not been a systematic strategy in meeting these challenges. Furthermore, deficiencies in public services, which result from urban underinvestment, place stress on an important part of their economic and social potential.

Under what conditions can cities collect a portion of the wealth generated within their territory, in order to finance development? With support from the AFD, the French Ministry of Foreign Affairs, and the French Department for International Development, the city of Rabat, along with experts in a number of fields, gathered to discuss on this issue. They attempted to analyse public policy mechanisms for financing urbanization. On the one hand, this session was organised based on an analysis of the literature. On the other, it was based on case studies carried out by the financial managers of 6 cities across 4 continent (Addis Ababa, Gothenburg, La Paz, Marrakesh, Ulaanbaatar, and Sfax). The results of this have fuelled UCLG's advocacy on local finances, whose integrated analysis was summarised into the 5 major recommendations outlined above.

Recurrent resource mobilization strategies directly linked to a national context

The status of the cities samples demonstrates inadequate autonomous resources. With the exception of Gothenburg, which has a real decision-making capacity in adjusting its level of revenue according to its spending needs, other cities do not have power on tax rates yet. Furthermore, the possibility of establishing new taxes is generally nonexistent. Financial transfers from the state level comprise a significant, if not dominant, part of these cities' recurrent resources.

The structure of their fiscal resources shows no positive relationship between the number of local taxes and the amount of revenue collected. Rather, it shows the opposite, including in terms of fees charged. The significant increase in local authorities' tax revenues must undoubtedly rely on a high-yield tax sharing agreement, as a fundamental step.

Recurrent resource mobilization strategies for the cities sampled can be analysed with regards to the level of decentralization of their respective countries:

› **As a result, where the institutional framework, economic growth and the financial environment allow it**, local authorities have mobilized shared tax resources as a priority. This is due to a positive development of the tax bases (Addis Ababa), along with an increase in tax rates (Gothenburg), the context of a relevant abundance of oil and gas resources (La Paz), or the prominent administrative and economic position of Ulaanbaatar as a capital.

› **However, the legislative and regulatory environments in Marrakesh and Sfax do not leave room for anything other than niche tax strategies,** which are actively exploited in Sfax, for example, with regards to undeveloped land, taxes on parking spaces, and advertising.

Land: An important resource for growth

Due to multiple factors, local financing from increasing land and property values remains largely below its potential. These revenues represent between 3.5% (Gothenburg) and 24% (La Paz) of the current income of the sampled cities (Ulaanbaatar 5.4%, Sfax: 6.75%, Addis Ababa: 10%, Marrakesh 16.5%):

› **Taxes on land and property ownership represent a major part of these resources, whose management may be vastly improved ,** dby updating property registration and property value, improving collection, and by increasing tax rates.

› **The other part of these resources comes through land management, which is controlled by the municipality. These could be tapped further** through a more accurate property census, competitive pitch between leases and transfers, the use of development projects, or such as through “land vs. infrastructure” processes of exchange.

A very uneven use of external resources

› **Ulaanbaatar is an exception within the sample, as it has not yet been able to mobilize external resources through borrowing to finance its investments. Unlike other cities, it instead looks towards PPPs as the preferred tool for external funding strategies for the future.**

› **Gothenburg uses debt as a preferred financing means, and developed a framework policy for debt management that combines the mutualisation of its treasury with all municipal companies, as well as diversification and differentiation strategies (notably, green bonds).**

› **Marrakesh and Sfax also experience a relatively high debt ratio. Although this limits their capacity to engage in proactive local policies on debt management, within the context of a de facto monopoly by the State bank, it allows them, at least in part, to meet their financing needs.**

› **La Paz has historically borrowed in financial markets, but currently finds itself blocked by the fact that the central government has reached on its own the total amount of international credit allowed by law. Ulaanbaatar is in the same situation without ever having the possibility of borrowing in the past.**

› **Addis Ababa has little recourse to borrowing but its revenue sources are diversified.**

THE COMMITTEE ON LOCAL FINANCE FOR DEVELOPMENT:

Created in 2006 and chaired by the city of Rabat - Morcco, the missions of the UCLG Committee on Local Finance and Development are:

THE ORGANIZATION OF HIGH-LEVEL POLITICAL DEBATES, to drive and spread UCLG advocacy on fiscal decentralization during major national and international events.

TO CONDUCT A GLOBAL OBSERVATORY ON LOCAL FINANCE

Data collection on local finance

- Develop a transparent, reliable updated database to have a global overview of the financial situation of local governments throughout the world.
- This database relies on national data furnished by UCLG members and partners, to complement the GOLD observatory.

A platform of knowledge and expertise

- **A global network of experts committed to:** Analyzing and disseminating data to support the advocacy.
- Conducting specific studies on strategic topics
  - The conditions for the mobilization of local resources.
  - Financial guarantee mechanisms.
- Within this network, particular attention is being paid to Chiefs Financial Officers at the local level.

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