



United Cities and Local Governments
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UCLG POLICY PAPER ON LOCAL FINANCE

SETTING THE BACKGROUND CURRENT TRENDS AND REALITIES FACING LOCAL GOVERNMENTS

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

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

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

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

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

¹ The World Bank has estimated that investment needs in public infrastructure in developing countries will amount to \$600 billion per year over the next 25 five years. The UCLG Committee has estimated that one third of this amount, i.e. 0.4% of the World GDP, would need to be channelled to urban infrastructure.

² Within the World Bank Group, only 8% of the total amount of loans (worth US\$ 22.3 bn in 2005) was assigned to urban infrastructure and development (US\$ 1.9 bn).

³ According to a World Bank study, over the 1984 2003 period, PPP focusing on urban infrastructure came to only to US\$ 60 bn (i.e. 10% of the total of investments realized through PPP over this period) in just a handful of countries of South America and East Asia.

⁴ AFD research has shown that local public borrowing is about US\$ 12 bn per year in mainly 17 countries (which include the G7 countries).

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

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

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

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

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

On the demand side:

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

On the supply side:

Significant efforts are needed to provide local governments with effective access to finance, credits and loans, to realize the needed local public infrastructure. Given that private markets and banks are not serving local governments, (mainly for structural reasons), public intervention is often needed to promote local public infrastructure long-term financing, whether through the funding of financial institutions and the development of specific legislation. In particular, the procedures of finance bodies that specialize in lending to local governments (the so called Municipal Development Funds) need to be reviewed to allow small and medium-sized authorities greater access to long-term borrowing in their local currency and at affordable rates of interest. Innovative mechanisms, aimed at freeing up available local savings and cash assets for local infrastructure, should be envisaged and implemented.

Meeting the Urban Challenge: 25 Recommendations for Enabling Effective Local Government Access to Local Infrastructure Financing

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

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

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

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

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

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

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

B. Establish National Strategies to Boost Local Public Investments:

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

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

Central governments are called to:

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

Local governments should commit to:

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

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

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

1.2 Link financial autonomy and accountability.

Central governments are called to:

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

Local governments should commit to:

11. High standards of efficient management and transparency, in return to the additional financial means provided.
12. Develop their capacities and pro-actively participate in peer to peer practices.
13. Promoting citizen participation.

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

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

Central governments are called on to:

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

Local governments should commit to:

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

Multilateral financial institutions and donors should:

17. Establish a coherent global strategy to meet the investment needs of small and medium-sized authorities. This will necessarily require a revision of their existing commitments.
18. Increase the volume of loans directly channelled to local governments, with or without sovereign guarantee.
19. Improve the quality of the loans provided by: extending the period of loans; reducing the interest rates offered through grant blending; and lending in national currency.

2.2 Strengthen together aid effectiveness, transparency and ownership.

Financial institutions and donors are called on to:

20. Improve efficiency and transparency of development programmes, consistent with the Declaration of Paris on Aid Effectiveness, and systematically include local governments in the design and implementation of aid instruments.
21. Contribute to improved cooperation between UN agencies, in line with the recommendations of the UN reform panel, mandated by Kofi Annan on the UN reform⁵.

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

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

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

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

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

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

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

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



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